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IMPUTED INTEREST

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

S. 56, S. 71, S. 217, S. 251, S. 729, and H.R. 2475

MAY 20, 1985

Printed for the use of the Committee on Finance

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CONTENTS

Administration Witnesses

Page

Pearlman, Hon. Ronald A., Assistant Secretary for Tax Policy, Department of the Treasury 50

Public Witnesses

Building Owners & Managers Association International, Charles Feldewert, secretary-treasurer 189
Driesler, Stephen D., executive vice chairmen, National Multi-Housing Council 225
Feldewert, Charles, secretary-treasurer, Building Owners & Managers Association International 189
International Council of Shopping Centers, John Syzmanski, government affairs committee 204
Melcher, Hon. John, a U.S. Senator from the State of Montana 38
Metzenbaum, Hon. Howard M., a U.S. Senator from the State of Ohio 44
National Apartment Association, Scott L. Slesinger, executive vice president 147
National Association of Home Builders, David C. Smith, first vice president 112
National Association of Realtors, Clark E. Wallace, president-elect 92
National Federation of Independent Business, Abraham Schneier, issue coordinator, taxes 181
National Multi Housing Council, Stephen D. Driesler, executive vice chairman 225
National Realty Committee, Steven A. Wechsler, vice president and general counsel 129
Schneier, Abraham, issue coordinator, taxes, National Federation of Independent Business 181
Slesinger, Scott L., executive vice president, National Apartment Association 147
Smith, David C., first vice president, National Association of Home Builders 112
Szymanski, John, government affairs committee, International Council of Shopping Centers 204
Wallace, Clark E., president-elect, National Association of Realtors 92
Wechsler, Steven A., vice president and general counsel, National Realty Committee 129

Additional Information

Committee press release 1
Description of bills S. 56, S. 71, S. 217, S. 251, S. 729, and H.R. 2475 by the Joint Committee on Taxation 3
Opening statement of Senator Robert Dole 36
Opening statement of Senator George J. Mitchell 36
Opening statement of Senator Durenberger 38
Prepared statement of Senator John Melcher 40
Prepared statement of Hon. Ronald A. Pearlman 63
Prepared statement of Clark E. Wallace 94
Prepared statement of David C. Smith 114
Prepared statement of Steven A. Wechsler 131
Prepared statement of Scott L. Slesinger 149
Prepared statement of Abraham Schneier 183
Prepared statement of Charles Feldewert 191
Prepared statement of John Syzmanski 206
Prepared statement of Stephen D. Driesler 227

Page

COMMUNICATIONS

Prepared statement of Senator John W. Warner of Virginia 245
The Continuing Care Coalition 248
American Farm Bureau Federation 257
American Health Care Association 258
Coopers & Lybrand 261
Charles F. Buckley & Associates, Inc 276
The Club Corp. of America and the National Club Association 277
IMB Credit Corp 291
The New York State Mortgage Loan Enforcement & Administration Corp 302
Lawrence E. Wright, broker associate 307

IMPUTED INTEREST

MONDAY, MAY 20, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable John H. Chafee (chairman) presiding.

Present: Senators Chafee, Wallop, and Symms.

[The press release announcing the hearing, the description of the bills S. 56, S. 71, S. 217, S. 251, S. 729, and H.R. 2475 by the Joint Committee on Taxation, and the prepared statements of Senators Dole and Mitchell follow:]

[Press Release No. 85-027]

IMPUTED INTEREST BILLS DUE MAY 20 HEARING IN FINANCE COMMITTEE

Five bills which would amend the Internal Revenue Code to clarify the application of imputed interests and interest accrual rules will be reviewed in a Committee on Finance subcommittee hearing announced today by Senator Bob Packwood (R-Oregon), Chairman of the Committee.

The hearing before the Committee on Finance's Subcommittee on Taxation and Debt Management is scheduled to begin at 9:30 a.m., Monday, May 20, 1985, Chairman Packwood said.

The hearing will be in Room SD-215 of the Dirksen Senate Office Building.

Senator Packwood said Senator John Chafee (R-Rhode Island), Chairman of the Subcommittee on Taxation and Debt Management, would preside at the hearing.

The five bills to be reviewed at the hearing are:

S. 56, authored by Senator James Abdnor (R-South Dakota), a bill to amend the Internal Revenue Code of 1954 to modify the application of the imputed interest and interest accrual rules in the sale or exchange of property.

S. 71, authored by Senate Majority Leader Bob Dole (R-Kansas) and Senator John Warner (R-Virginia), a bill to modify the application of the imputed interest rules under the Internal Revenue Code.

S. 217, authored by Senator John Melcher (D-Montana) and Senator Carl Levin (D-Michigan), a bill to amend the code to make permanent the rules relating to imputed interest and assumption of loans, and for other purposes.

S. 251, authored by Senator Dave Durenburger (R-Minnesota), with three co-sponsors, Senator Edward Zorinsky (D-Nebraska), Senator Rudy Boschwitz (R-Minnesota) and Senator John Heinz (R-Pennsylvania), a bill to amend the Code to make permenent the rules relating to imputed interest and the assumption of loans, and for other purposes.

S. 729, authored by Senator Durenberger, with 21 co-sponsors, a bill to amend the Code to make permanent the rules relating to imputed interest and assumption of loans, and for other purposes.

Senator Packwood noted the Congress faced a July 1, 1985, deadline on the imputed interest issue.

"We adopted a temporary compromise to this most important issue on October 11, 1984," the Committee on Finance Chairman said. "But the measure we approved last fall liberalized the imputed interest rules for seller-financed property transactions only through July 1 this year.

"In the coming weeks, both houses of Congress must agree on a bill to provide permanent relief to property owners who utilize seller-financing," Senator Packwood said. I am confident we can find a solution which will protect homeowners, farmers and ranchers, and small business owners."

The Chairman pointed out, "There is still a very real need to guard against the most egregious tax shelter abuses under the old law—which we attempted to address in the Deficit Reduction Act of 1984. But we must also protect the legitimate uses of seller financing.

"It is impossible to please everyone, especially in an issue of this magnitude," Senator Packwood said. "But I am confident we can perfect a package which will serve the best interest of all parties to this protracted dispute," he said.

DESCRIPTION OF THE TAX TREATMENT OF IMPUTED INTEREST ON DEFERRED PAYMENT SALES OF PROPERTY

(And S. 56, S. 71, S. 217, S. 251, S. 729, and H.R. 2475, As Reported by the House Committee on Ways and Means)

Scheduled for a Hearing

before the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

of the

SENATE COMMITTEE ON FINANCE

ON MAY 20, 1985

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Senate Committee on Finance has scheduled a public hearing on May 20, 1985, to review the imputed interest rules of the Internal Revenue Code of 1954 as amended by the Deficit Reduction Act of 1984 (P.L. 98-369) (hereafter called the "1984 Act") and by the subsequent temporary legislation (P.L. 98-612) (hereafter called the "stopgap legislation"). Certain provisions of the stopgap legislation expire on July 1, 1985. The amendments made by the 1984 Act modified the imputed interest rules of prior law and expanded the original issue discount rules of prior law to apply to deferred payment obligations created in sales or exchanges of nonpublicly traded property. The pamphlet collectively refers to these rules as the imputed interest rules. Five Senate bills are listed for the Subcommittee hearing: S. 56, S. 71, S. 217, S. 251, and S. 729.

The first part of the pamphlet[1] is a summary. The second part discusses the rules of present law relating to imputed interest and original issue discount. The third part provides an historical background of the development of the imputed interest rules. The fourth part provides an analysis of the effect of the imputed interest rules and the issues presented by those rules. Finally, the fifth part provides a description of the five Senate bills (S. 56, S. 71, S. 217, S. 251, and S. 729) that have been introduced thus far in the 99th Congress that affect the imputed interest rules, as well as a description of H.R. 2475, as reported by the House Committee on Ways and Means on May 14, 1984 (H.R. Rep. No. 99-87).

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of the Tax Treatment of Imputed Interest on Deferred Payment Sales of Property (and S. 56, S. 71, S. 217, S. 251, S. 729, and H.R. 2475, as reported by the House Committee on Ways and Means)* (JCS-15-85), May 17, 1985.

I. SUMMARY

Present Law Rules

The amendments to the imputed interest rules adopted by Congress in the 1984 Act were part of a series of modifications to the Internal Revenue Code designed to account more properly for the time value of money. A principal motivation for these changes was to address perceived abuses by tax shelters.

The 1984 Act made two basic modifications to the Federal income tax treatment of imputed interest. First, the Act attempted to correct deficiencies in the then-existing imputed interest rules by providing that the amount of imputed interest would be determined by reference to an interest rate tied to the yields on U.S. Treasury obligations, instead of a fixed rate set by the Treasury Department. Under the 1984 Act, if interest is not stated at a rate at least 110 percent of the average yield on Treasury obligations, then interest is imputed into the transaction at a rate equal to 120 percent of the Federal rate. The effect of imputing interest income into the transaction is not to increase the amount paid by the buyer to the seller, but to recharacterize a portion of the payments (designated as principal by the parties) as interest for Federal income tax purposes.

Second, the 1984 Act expanded the rules dealing with original issue discount to cover many deferred payment obligations arising from the the sale of property. The purpose of this change was to ensure that interest deductions taken by the buyer during a year do not exceed the interest income reported by the seller during that year.

In response to concerns expressed about the potential impact of the new rules, Congress passed the stopgap legislation at the end of the 98th Congress. Under the stopgap legislation, the test rate on the first $2 million of borrowed amounts is 9 percent on sales or exchanges of property occurring before July 1, 1985.

Senate Legislative Proposals

In the current session, five Senate bills have been introduced relating to the imputed interest rules. S. 56 and S. 71 generally would provide various lower rates at which interest must be stated in order to avoid the imputation of additional interest. Whether a lower rate may be specified and, if so, what that rate would be is determined by reference to the nature of the property sold, the term and amount of the debt, and the extent to which interest is paid currently. These bills would apply the imputed interest rules to the assumption of all debt instruments that were issued after October 15, 1984, and to the assumption of debt instruments issued on or before that date where the assumption is in connection with the sale or exchange of property, the selling price of which exceeds $100 million.

S. 217, S. 251, and S. 729 each would provide a lower rate at which interest must be stated to avoid the imputation of additional interest, and also a lower rate for imputing additional interest. Also, under these bills, assumed loans generally would be excepted from the imputed interest rules.

H.R. 2475 as Reported by the Committee on Ways and Means

H.R. 2475 was reported by the House Committee on Ways and Means on May 14, 1985 (H.R. Rep. No. 99-87). Under H.R. 2475, the rate used to determine whether there is adequate interest in a transaction is the lower of 9 percent and 100 percent of the AFR where the amount of seller financing does not exceed $2 million. The rate is 100 percent of the AFR for seller-financed amounts of $4 million or more. Where the amount of seller financing is in between $2 million and $4 million, the rate is a blend of the lower of 9 percent and 100 percent of the AFR on the first $2 million reduced dollar-for-dollar by the amount of seller financing that exceeds $2 million, and 100 percent of the AFR on the excess.

H.R. 2475 also provides that the rate used to impute interest into the transaction is to be the same as the rate used to determine whether stated interest is adequate (i.e., there would be no higher "penalty rate" where inadequate interest is stated). Further, H.R. 2475 allows the parties to elect jointly to account for interest from certain seller-financed debt instruments not exceeding $2 million, under the cash method of accounting. In order to offset the revenue loss from the modifications of the imputed interest rules, H.R. 2475 increases the recovery period for real property (other than low-income housing) from 18 years to 19 years.

II. PRESENT LAW: OID AND IMPUTED INTEREST RULES

A. The Original Issue Discount Rules

Treatment of original issue discount as interest

If the borrower in a lending transaction receives less than the amount to be repaid at the loan's maturity, then the difference represents "discount." Discount performs the same function as stated interest, i.e., compensation of the lender for the use of the lender's money.[2] Code sections 1272 through 1275 and section 163(e) (the "OID rules") generally require the holder of a debt instrument issued at a discount to include annually in income a portion of the original issue discount ("OID") on the instrument, and allow the issuer of such an instrument to deduct a corresponding amount, irrespective of the methods of accounting that the holder and the issuer otherwise use.[3]

Definitions

Original issue discount" is defined as the excess of a debt instrument's "stated redemption price at maturity" over its "issue price" (provided such excess is not less than a certain *de minimis* amount).

"Issue price" is generally (1) in the case of a cash loan, the amount borrowed, (2) in the case of a debt instrument that is issued for property where either the debt instrument or the property is publicly traded,[4] the fair market value of the property, or (3) if neither the debt instrument nor the property exchanged for it is publicly traded, the amount determined under section 1274, as discussed below.

"Stated redemption price at maturity" includes all amounts payable at maturity excluding any interest based on a fixed rate and payable unconditionally over the life of the debt instrument at fixed intervals no longer than one year.

Operation of the OID rules

The amount of the OID in a debt instrument, if any, is allocated over the life of the instrument through a series of adjustments to the issue price for each "accrual period" (i.e., each six-month or shorter period ending on the calendar day corresponding to the date of the debt instrument's maturity and the date six months prior to the date of maturity). The adjustment to the issue price for each accrual period is determined by multiplying the "adjusted issue price" (i.e., the issue price increased by adjustments prior to the beginning of the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period. The adjustment to the issue price for any accrual period is the amount of OID allocated to that accrual period. These adjustments reflect the amount of the accrued but unpaid interest on the debt instrument in each period. The holder is required to include this amount as interest income and the issuer is permitted a corresponding interest deduction.[5]

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[2] *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965); *see also Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[3] Prior to 1982, the OID rules applied only to a limited class of obligations. The Tax Equity and Fiscal Responsibility Act of 1982 and the 1984 Act greatly expanded the number and types of obligations to which the OID rules apply.

[4] Presently, only stock or securities traded on an established securities market are treated as publicly traded. However, section 103 of the Technical Corrections Act of 1985 (S. 814) would grant the Treasury Department authority to issue regulations treating as publicly traded other property "of a kind regularly traded on an established market."

B. Determination of Issue Price in Debt-for-Property Transactions: Section 1274

In general

Section 1274, added by the 1984 Act, performs two roles. First, section 1274 tests the adequacy of stated interest in certain debt instruments issued for nonpublicly traded property and, where stated interest is inadequate, recharacterizes a portion of the principal of the debt instrument as interest. Second, section 1274 prescribes the issue price of the debt instrument. If the issue price so prescribed is less than the debt instrument's stated redemption price at maturity, the application of the OID rules will require the issuer and the holder of the debt instrument to use the accrual method of accounting for any interest (whether stated or imputed) that is not paid currently. Thus, the impact of section 1274 is to require the lender and borrower to account for interest annually in an amount equal to the greater of the stated interest rate or a rate deemed to be adequate (i.e., the "imputation rate," described below).

Subject to certain exceptions, described below, section 1274 determines the issue price of a debt instrument issued in connection with the sale or exchange of property if (1) neither the instrument nor the property received in exchange for the instrument is publicly traded; (2) some or all of the payments under the instrument are due more than six months after the sale; and (3) the stated redemption price at maturity of the instrument exceeds its stated principal amount (if there is adequate stated interest) or its "imputed principal amount" (if there is inadequate stated interest).

Determination of issue price and amount of OID under section 1274

The issue price of an obligation subject to section 1274 is the stated principal amount of the instrument unless there is inadequate stated interest. In order to determine whether stated interest is adequate, the stated principal amount of the debt instrument is compared with the "testing amount"—the amount determined by discounting all payments due under the instrument at a prescribed "test rate." An instrument contains adequate stated interest if the stated principal amount is less than or equal to the testing amount.

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[5] The premise of the OID rules is that, for Federal income tax purposes, an obligation issued at a discount should be treated like an obligation issued at par requiring current payments of interest. Accordingly, the effect of the OID rules is to treat the borrower as having paid to the lender semiannually the interest accruing on the outstanding principal balance of the loan, thereby permitting the borrower to deduct as interest expense and requiring the lender to include in income such interest which has accrued but is unpaid. The lender is then deemed to have lent the accrued but unpaid interest back to the borrower, who in subsequent periods is deemed to pay interest on this amount as well as on the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the "economic accrual" of interest, or interest "compounding."

If a debt instrument does not contain adequate stated interest, section 1274 deems the principal amount (and the issue price) of the instrument to be the "imputed principal amount." The imputed principal amount is the amount determined by discounting all payments due under the instrument using a prescribed "imputation rate," which is higher than the test rate.

In effect, where section 1274 applies, if the debt instrument does not bear interest at a rate at least equal to the prescribed test rate, interest will be imputed at a higher imputation rate. Moreover, if such interest is not unconditionally payable at least annually,[6] the OID rules will require periodic inclusion and deduction of the accrued but unpaid interest. The OID rules also apply if an instrument provides for adequate interest payable at least annually, but also provides for fixed additional amounts of interest that are not paid currently. In such a case, the instrument is deemed to contain OID equal to the additional interest. Pursuant to the OID rules, a portion of this OID is reported as income by the lender and deducted by the borrower currently.[7]

"Test rates" and "imputation rates"

Under section 1274, whether there is adequate stated interest in a transaction is determined by reference to an appropriate test rate. The test rate for a debt instrument subject to section 1274 is the rate in effect on the first day there is a binding contract for the sale or exchange of the property. All test and imputation rates are applied using semiannual compounding.

General rule.—For sales or exchanges after December 31, 1984, of new property eligible for the investment credit, and for all sales or exchanges after June 30, 1985, the test rate is 110 percent of the "applicable Federal rate," and the imputation rate is 120 percent of the "applicable Federal rate."

Applicable Federal rate.—The applicable Federal rate ("AFR") for a debt instrument is the lower of two published rates, one specified by the 1984 Act and one specified in temporary Treasury regulations. The statutory rate is based on the weighted average of yields over a period of six months for marketable obligations of the United States Government with a comparable maturity. Such rates are redetermined at six-month intervals for three categories of debt instruments: short-term maturity (three years or less), mid-term maturity (more than three years but not in excess of nine years), and long-term maturity (more than nine years).[8]

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[6] As discussed below, the prescribed test rates are based on semiannual compounding. Accordingly, if interest is payable annually, the amount payable must reflect the compounding of the test rate. If interest is payable at intervals more frequent than semiannual, the nominal rate may be adjusted appropriately. For illustration of the adjustments to the prescribed rate based on the intervals at which interest is paid, *see, e.g.*, Rev. Rul. 85-58, 1985-18 I.R.B. 5.

[7] An exception from the accrual accounting requirement is provided for debt issued in connection with sales of property not eligible for the investment credit and used in the active trade or business of farming. This exception applies only if the sale takes place after December 31, 1984, and prior to July 1, 1985, and the borrowed amount does not exceed $2 million. Interest on such debt is accounted for by both the borrower and the lender on the cash method of accounting.

The rates determined under the temporary Treasury regulation are intended to reflect more accurately the current marketplace.[9] These rates are computed monthly using the same methodology described above, except that the rates reflect the average yields for one-month periods. In any month, the lower of the six-month rate or the monthly rate is the AFR. However, in cases where the monthly rate for either of the two preceding months is lower than the AFR for a particular month, the test rate for that month is the lower of the two such rates.

Special rule for certain transactions before July 1, 1985.—For sales or exchanges after December 31, 1984, and before July 1, 1985, of property other than new property eligible for the investment credit, the test rate for "borrowed amounts" not exceeding $2 million is 9 percent. The test rate for borrowed amounts exceeding $2 million is a "blend" of 9 percent on the first $2 million and 110 percent of the AFR on the excess. In applying the $2 million limitation, all sales or exchanges that are part of the same transaction (or a series of related transactions) are treated as one transaction, and all debt instruments arising from the same transaction (or a series of related transactions) are treated as one debt instrument. The imputation rate for transactions during this same period is 10 percent for borrowed amounts up to $2 million and a blend of 10 percent and 120 percent of the AFR for borrowed amounts exceeding $2 million.

Limitation on principal amount of a debt instrument

Notwithstanding the computation of "issue price" discussed above (and, accordingly, the buyer's basis in the property), the principal amount of any debt instrument under section 1274 in a "potentially abusive situation" is equal to the fair market value of the property sold.[10] This limitation applies whether the stated interest is adequate or inadequate under section 1274.

A potentially abusive situation includes any transaction involving a "tax shelter" (as defined in sec. 6661(b)(2)(C)(ii)). It also includes any other situation that, because of (1) recent sales transactions, (2) nonrecourse financing, (3) financing with a term beyond the economic life of the property, or (4) other circumstances, is of a type which the Treasury Department by regulation identifies as having a potential for abuse.

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[8] Appropriate adjustments to the rates are to be made for application to debt instruments, the interest on which is wholly or partly exempt from tax (sec. 1288).

[9] The mechanism provided by the temporary regulations is intended to respond to a problem that may exist where interest rates decline after the period in which the Federal rates were determined.

[10] The principal amount of the note is reduced to reflect the fair market value of other consideration involved in the transaction. This provision prevents both overstatement *and* understatement of the buyer's basis in the property. The purpose of the latter restriction is to prevent the intentional overstatement of OID. A taxpayer might be motivated to overstate the interest element of a sale, for example, if the property involved in the sale were nondepreciable or the seller were not subject to U.S. tax on interest income.

Exceptions

Specific exceptions are provided for certain debt instruments that otherwise would be subject to section 1274. However, these debt instruments may be subject to the rules of section 483. As discussed below, section 483 tests the adequacy of interest in a debt instrument without requiring annual inclusion and deduction of accrued but unpaid interest. Debt instruments that are excepted from section 1274 are as follows:

Personal-use property.—Issuers (but not holders) of debt instruments issued in exchange for property, substantially all of which will not be used by the issuer in a trade or business or held by the issuer for the production or collection of income, are excepted from section 1274. Accordingly, a cash-method issuer of such an obligation may claim interest deductions only for amounts of stated interest actually paid during the taxable year.

Annuities.—Section 1274 does not apply to an annuity to which section 72 applies and the liability for which depends in whole or in substantial part on the life expectancy of any individual. In addition, section 1274 does not apply to any annuity (whether or not dependent upon life expectancy) issued by an insurance company (subject to tax under Subchapter L), provided the annuity is issued (1) in a transaction in which only cash or another annuity contract meeting the requirements of this exception is exchanged for the annuity, (2) upon exercise of an election under a life insurance policy by a beneficiary thereof, or (3) in a transaction involving a qualified pension or employee benefit plan.

Patents.—An exception is provided for payments attributable to a transfer of a patent, provided the transfer is eligible for capital gain treatment under section 1235 and such payments are contingent upon the productivity, use, or disposition of the patent. Thus, the exception does not apply in the case of a deferred lump-sum amount payable for a patent.

Farms.—Section 1274 does not apply to debt instruments received by an individual, estate, or testamentary trust, by a small business corporation (as defined in sec. 1244(c)(3)), or by certain partnerships[11] in exchange for a farm. This exception applies only if the sales price does not exceed $1 million.[12]

Principal residences.—Debt instruments received by an individual as consideration for the sale or exchange of that individual's principal residence (within the meaning of sec. 1034) are not subject to section 1274, regardless of the amount involved in the transaction.

Total payments not exceeding $250,000.—Section 1274 does not apply to any debt instrument given in exchange for property if the sum of (1) the payments due under the instrument (whether designated principal or interest) and under any other debt instrument given in the transaction, and (2) the fair market value of any other consideration given in the transaction, does not exceed $250,000.[13]

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[11] That is, those partnerships whose capital is not in excess of the limits specified in sec. 1244(c)(3).

[12] Sales and exchanges that are part of the same transaction or a series of related transactions are treated as one sale or exchange, in order to prevent taxpayers from avoiding the $1 million limitation by dividing what is in substance a single transaction into two or more smaller transactions. The exception for farms as well as the exceptions following are nevertheless subject to sec. 483, as more fully discussed in the text below.

Land transfers between related persons.—Section 1274 does not apply to an instrument to the extent that section 483(f), relating to certain sales of land between related parties, applies.

C. Measurement of Principal and Interest in Transactions Not Subject to the OID Rules: Section 483

In general

Section 483 generally applies to nonpublicly traded debt instruments given in exchange for nonpublicly traded property where such debt instruments are not subject to section 1274. Under section 483, an instrument is tested for adequate stated interest in the same manner, and using the same test rates, as under section 1274. Where stated interest is inadequate, section 483 recharacterizes a portion of the principal amount of the instrument as interest which, in general, is equal to the additional amount of OID that section 1274 would impute.[14]

However, unlike section 1274, section 483 does not require imputed interest (or stated interest) to be accounted for on an accrual basis. Stated interest on a debt instrument subject to section 483 is accounted for under the taxpayer's usual method of accounting. Imputed interest is accounted for by cash-method taxpayers when the payments, portions of which are recharacterized as interest by section 483 are made, or by accrual-method taxpayers when such payments are due. The portion of the imputed interest that is allocated to a payment is that portion of the total imputed interest which, in a manner consistent with the method of computing interest under the OID rules, is properly allocable to such payment.

Exceptions

Excepted transactions.—Section 483 contains the same exceptions for sales of personal-use property, annuities, and patents that apply to section 1274. In addition, section 483 does not apply where the sales price of the property does not exceed $3,000.

Lower test rates.— In the case of a sale after June 30, 1985, of a principal residence to the extent the purchase price does not exceed $250,000 or of farm land where the price does not exceed $1 million (where such sale would qualify for exception from section 1274), the test rate may not exceed 9 percent, and imputation rate may not exceed 10 percent. In addition, for sales or exchanges of land between an individual and that individual's brothers, sisters, spouse, ancestors or lineal descendants, the test rate under section 483 may not exceed 6 percent. This preferential rate applies only to the extent that the sales price of the land, and the sales price of all prior sales of land between the same individuals in a calendar year, does not exceed $500,000.

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[13] This exception is subject to an aggregation rule similar to that provided under the farm sale exception.

[14] For certain transactions, lower test and imputation rates are provided. These transactions are described in the text below.

D. Regulatory Authority Relating to Debt-For-Property Transactions

The Treasury Department has authority to issue regulations dealing with the treatment of transactions involving varying interest rates, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments not specifically dealt with in the statute, and other circumstances. The regulatory authority granted to the Treasury Department contemplates possible modification of the generally applicable rules where appropriate to carry out the purposes of the statute, including the provision of exceptions for transactions not likely to significantly reduce the tax liability of the purchaser by reason of overstatement of the basis of the acquired property.

Pursuant to its regulatory authority, the Treasury Department has provided the monthly rates in order to address the problems that may arise where the statutorily determined rates are significantly higher than prevailing market interest rates.

E. Assumptions of Debt in Connection With the Sale of Property

Neither section 483 nor section 1274 applies to the following debt obligations assumed in connection with the sale or exchange of property, or to debt obligations which property is taken subject to, provided that the terms and conditions of the obligation are not modified in connection with the sale:

Pre-October 16, 1984 obligations

Loans made on or before October 15, 1984, and assumed after December 31, 1984, in connection with a sale or exchange of property, are not subject to section 483 or section 1274 by reason of such assumption.[15] This exception does not apply, however, if the purchase price of the property exceeds $100 million.

Residences

Loans assumed in connection with a sale of a residence by an individual, estate, or testamentary trust are exempt from sections 483 and 1274 if either (1) at the time of the sale, the property was the seller's (or if applicable, the decedent's) principal residence (within the meaning of sec. 1034) or (2) during the two-year period prior to the sale, no substantial portion of the property was of a character subject to an allowance for depreciation. Thus, an assumption of a loan in connection with the sale of a principal residence, or of a vacation home on which a taxpayer may not claim depreciation (e.g., by reason of sec. 280A), generally is not subject to testing for unstated interest under sections 483 or 1274. This exception does not apply, however, to a sale of property that was at any time held by the seller for sale to customers in the ordinary course of business.

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[15] The exceptions relating to assumptions of loans also apply to loans which property may be taken subject to.

Farms

Neither sections 483 or 1274 apply to loans assumed in connection with a sale by a "qualified person" of real property used as a farm (within the meaning of sec. 6420(c)(2)) at all times during the three-year period prior to the sale. The exception also applies to loans assumed in connection with the sale of tangible personal property used by the seller of such a farm in the active conduct of a farming business that is also sold in connection with the sale of such a farm for use by the buyer in the active conduct of a farming business. The term "qualified person" includes an individual, estate, or testamentary trust, or a corporation or partnership having 35 or fewer shareholders or partners immediately prior to the sale or exchange, owning at least a 10-percent interest in the property sold.

Trades or businesses

Loans assumed in connection with a sale by a "qualified person" of a trade or business are exempt from sections 483 and 1274. Trade or business has the same meaning as under section 355, except that the rental of real estate under no circumstances qualifies as an active business for this purpose. For purposes of this exception, the term "qualified person" has the same meaning as in the exception for assumptions in connection with the sale of farm properties except that the sale must constitute a disposition of the seller's entire interest in the trade or business and in all substantially similar trades or businesses.

An exception is also provided for a sale of real property used in an active trade or business (as defined above) by someone who would be a qualified person but for the fact that his entire interest in the trade or business is not being sold. Thus, for example, loans assumed in connection with a casual sale by a sole proprietor of real property used in his business could be exempt from sections 1274 and 483.

The trade or business property exception does not apply to a sale of property qualifying under the farm exception, or to property that is new property eligible for the investment credit in the buyer's hands.

III. HISTORICAL BACKGROUND

A. Imputed Interest Rules

Imputed interest rules were first enacted in 1964 in response to a perceived potential for abuse in installment sales of property. Prior to that time, some courts had held that, where the parties to a sale provided contractually that no interest was due on deferred payments or that interest was payable at a rate below the prevailing market rate, the contract's designation of payments as principal or interest generally must be respected for tax purposes.

Congress recognized that it was possible for taxpayers to achieve significant tax benefits by structuring a transaction to include a below-market rate of interest. When a contract states an inadequate interest rate, however defined, the seller's "amount realized" and the buyer's basis for depreciation of the property is overstated because interest payments have been characterized as sales price, or loan principal.[16]

This recharacterization of interest as sales price, although not affecting actual amounts paid, could have important tax consequences. If the property sold was a capital or a section 1231 (trade or business) asset to the seller, then the seller would have transformed interest income, which should be taxable currently as ordinary income, into capital gain income. If the property was depreciable in the hands of the purchaser, then the buyer would have been entitled to higher depreciation deductions. If the property was tangible personal property used in a trade or business or held for the production of income, then the buyer would have been entitled to a larger investment credit.

As originally enacted, section 483 determined whether the parties to a deferred-payment transaction had stated adequate interest in the sales contract by comparing the rate agreed to by the lender to the minimum "safe harbor" or "test" rate. Where interest was not stated at least at this minimum rate, section 483 imputed interest at a higher "imputation" rate, allocating each deferred payment between interest and principal by looking at the relative amounts of the payments.[17] The amount of the test and imputation rates was set by the Treasury Department. Just prior to the 1984

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[16] To illustrate, assume a sale of property with a value of $100 when the prevailing interest rate is 12 percent. The buyer agrees to pay and the seller agrees to accept $176 at the end of 5 years. From an economic standpoint, this $176 consists of $100 principal and $76 interest. Prior to the enactment of section 483, the parties might have been able to structure the transaction as a sale for a larger purchase price but at a reduced rate of interest. For example, the transaction could have been structured as a sale for a $153 note bearing simple interest at a rate of 3 percent simple interest, without affecting the economics of the transaction.

[17] The amount of imputed interest allocated to a particular payment was the amount of imputed interest multiplied by the ratio of the amount of the payment to the total deferred payments.

Act, the safe harbor rate was 9 percent simple interest and the imputation rate was 10 percent, compounded semiannually.

In amending section 483 in 1984, Congress sought to remedy some of the perceived deficiencies in the statute that had led in some cases to abuses by taxpayers. One perceived deficiency was the test rate. The simple interest rate under prior law did not reflect fair-market third party rate of interest for three reasons. First, although the rate was occasionally changed by the Treasury Department,[18] it lagged significantly behind market interest rates. Second, the statute's use of a simple test rate ignored the compounding of interest on unpaid interest that occurs in all lending transactions. Finally, the use of a single rate for all obligations regardless of the length of maturity failed to reflect the fact that lenders typically demand different returns depending on the term of the loan.

Another deficiency of the statute was the method of allocating imputed interest among payments. Some tax shelters attempted to exploit this method by deliberately structuring sales transactions to be treated as having inadequate interest for purposes of section 483. Under a literal application of the statute and regulations, several years' interest charges arguably could be deducted by the buyer in the year of sale.

The potential for overstatement of purchase price and tax basis increased as market interest rates reached historically high levels. Moreover, the enactment of the Accelerated Cost Recovery System ("ACRS") in 1981 placed additional pressure on the imputed interest rules creating a greater incentive to overstate the basis of property. The liberal cost recovery allowances permitted under ACRS made it more likely that a buyer would be better off from a tax standpoint with a high purchase price and smaller interest deductions, than with a low purchase price and larger interest deductions. Thus, both parties could have a tax incentive to understate interest, and were permitted to do so by virtue of the interest rate specified as a safe harbor in the section 483 regulations.

B. Original Issue Discount

Prior to the Tax Reform Act of 1969, an accrual-method borrower could take deductions for accrued but unpaid interest while a cash-method lender could defer interest inclusions until maturity. Concern over the mismatching of interest income and deductions by lenders and borrowers in discount loan transactions led to the enactment in 1969 of provisions requiring inclusion in income of OID by the holder of certain debt obligations (former sec. 1232). The rules enacted in 1969 allocated OID on a straight-line basis over the life of the loan. The straight-line allocation allowed borrowers larger interest deductions in the earlier years of a discount loan than were justified under an economic accrual formula. Lenders were correspondingly required to report a disproportionately large amount of interest income in the early years of the loan. In recognition of the shortcomings of these rules, Congress made further amendments to the OID provisions in 1982. Under the 1982 rules, both issuers and holders were required to report OID on a constant interest basis.[19]

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[18] The Treasury Department had changed the rates two times in the 20 years since the enactment of the imputed interest rules.

Prior to 1982, the OID provisions applied only to corporate and taxable government obligations. The 1982 amendments extended these provisions to noncorporate obligations other than those of individuals. In addition, the OID rules prior to the 1984 act did not apply to obligations that were not capital assets in the hands of the holder, or obligations issued in exchange for property where neither the obligation nor the property received was publicly traded.

The stated reason for the exclusion of discount obligations issued for nonpublicly traded property where the obligations were themselves not publicly traded was the perceived difficulty in these situations of determining the value of the property sold, and hence the issue price of and the amount of OID implicit in, the obligation. If the value of property is not readily ascertainable, the allocation between principal and interest on the obligation becomes uncertain. As discussed above, the 1984 Act addressed this valuation problem by using a modified version of the approach used in section 483 to determine the principal amount of the loan.

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[19] In 1983, the Internal Revenue Service issued a revenue ruling proscribing the deduction of interest in an amount in excess of the economic accrual of interest for the taxable year. In Rev. Rul. 83-84, 1983-1 C.B. 9, the Service ruled that the amount of interest attributable to the use of money for a period between payments must be determined by applying the effective rate of interest on the loan to the unpaid balance of the loan for that period. The unpaid balance of the loan is the amount borrowed plus the interest earned, minus amounts previously paid. The effective rate of interest, which is a uniform rate over the term of the loan, is a measure of the cost of credit that relates the amount and timing of values received to the amount and timing of payments made; it is thus a reflection of the cost of the amount borrowed for the time it is actually available.

IV. ANALYSIS AND ISSUES

A. Determining the Proper Amount of Imputed Interest

Tax consequences of understatement of interest

Understatement of interest in a seller-financed sale of depreciable property results in an overstatement of both the buyer's depreciation deductions (and investment tax credit, if applicable) and the seller's capital gain, and an understatement of both the buyer's interest deductions and the seller's interest income. The net tax effect of understatement of interest depends on a variety of factors including (1) the relative tax rates of the buyer and seller, (2) the amount by which basis is overstated, (3) the depreciation method used, (4) the number of years the property is held by the buyer, and (5) the term of the seller-financed debt and (6) whether capital gains are reported on the installment method. In general, an overstatement of basis is advantageous for tax purposes to the extent that it results in a magnification of the tax benefits of rapid depreciation, capital gains treatment, and installment reporting. The consequences of overstating basis are demonstrated below in two examples involving the seller-financed sale of an office building for a purchase money note at (1) a market interest rate and (2) a below-market interest rate.

The first example involves the sale of a fully depreciated office building for a $100 million note with interest payable annually at 13.5 percent (assumed market rate) and a balloon payment of principal in 18 years. The buyer and seller are both taxable at a 50-percent rate (the highest individual income tax rate). In this case, the seller will recognize taxable capital gains income of $40 million ($100 million less the 60 percent capital gains exclusion) in the eighteenth year, giving rise to a tax liability of $20 million (assuming there is no depreciation recapture). Over the 18-year term of the note, the buyer will depreciate the full purchase price of the property, resulting in deductions of $100 million, and giving rise to a tax reduction of $50 million. Thus, the net effect of the sale is a reduction in tax revenues of $30 million ($50 million minus $20 million) over the 18 year period.[20] This example shows that a deferred payment sale of depreciable property generating capital gain for the seller can result in a reduction in tax revenues even if interest is stated at the market rate. However, the tax benefit arising from such a sale can, in many cases, be magnified as a result of understating interest.

In the second example, the parties to the sale of the office building, described above, agree to reduce the interest rate to 9.7 percent and, as an offset, to raise the purchase price to $133.4 million.[21] Thus, the principal amount of the note is overstated, relative to a market rate mortgage, by one-third ($133.4 vs. $100 million). In this case, the seller will recognize taxable capital gains income of $53.4 million ($133.4 million less the 60 percent capital gains exclusion) in the eighteenth year giving rise to a tax liability of $26.7 million (50 percent of $53.4 million). Over the 18-year term of the note, the buyer will depreciate the full purchase price of the property, resulting in deductions of $133.4 million, and giving rise to a tax reduction of $66.7 million (50 percent of $133.4 million). Thus, the net effect of the sale is a reduction in tax revenues of $40 million ($66.7 million minus $26.7 million) over the 18 year period.[22] This revenue loss is one-third greater than the $30 million revenue loss arising in the case where interest on the seller-financed mortgage was set at the market rate (see Table 1). Under the facts of this example, it can be concluded that the revenue loss arising from a sale of depreciable property increases in direct proportion to the overstatement of principal.

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[20] Interest payments of $13.5 million per year ($100 million times 13.5 percent) will be deducted by the buyer and included by the seller, resulting in no net revenue effect. Rental income from the property, and tax on this income, presumably would be unaffected by the sale.

Table 1.—Tax Consequences of Understatement of Interest

[Dollar amounts in millions]

Item	Market rate mortgage	Below market mortgage
Stated interest rate (percent)	13.5	9.7
Stated principal amount	$100.0	$133.4
Maturity (years)	18	18
Total depreciation deductions	$100.0	$133.4
Taxable capital gains income	$40.0	$53.4
Net reduction in taxable income [1]	$60.0	$80.0
Revenue loss over 18-year period [2]	$30.0	$40.0

[1] Total depreciation deductions less taxable capital gains income.

[2] Revenue loss computed assuming buyer and seller are both in the 50-percent income tax bracket.

The amount by which the principal amount of indebtedness is overstated relative to indebtedness bearing interest at a market rate depends primarily on three factors: (1) the maturity of the note, (2) the extent to which interest is stated below the market rate, and (3) the degree to which accrued interest is deferred (i.e., not paid currently). The effect of these factors on the overstatement of principal is illustrated in Figure 1. For purposes of this Figure, the prevailing mortgage interest rate is assumed to be 110 percent of the April 1985 AFR.

If interest is stated at 80 percent of the AFR in an interest-only note, rather than at the assumed market rate (110 percent of the

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[21] The present value (discounted at the assumed market rate) of interest and principal on a 9.7 percent loan of $133.4 million is approximately equal to that on a 13.5 percent loan of $100 million, both with a balloon payment of principal at maturity (18 years).

[22] Interest payments of $12.94 million per year ($133.4 million times 9.7 percent) will be deducted by the buyer and included by the seller, resulting in no net revenue effect. Rental income from the property, and tax on this income, presumably would be unaffected by the sale.

AFR), then the principal amount of indebtedness is overstated by 25 percent on a 10-year note, 34.5 percent on a 20-year note, and 37.5 percent on a 30-year note.[23] If a higher rate of interest is stated, for example 100 percent of the AFR, then overvaluation is reduced: the principal amount of indebtedness is overstated by 7.2 percent on a 10-year note, 9.4 percent on a 20-year note, and 10.1 percent on a 30-year note.[24] By contrast, if interest is again stated at 100 percent of the AFR but all interest payments are deferred to the date of maturity, then the amount of overvaluation is much greater: 11.8 percent on a 10-year note, 25 percent on a 20-year note, and 39.8 percent on a 30-year note. Thus, on a 30-year note, roughly equal amounts of principal overstatement can be achieved by (1) deferring all payments on a note that bears interest at 100 percent of the AFR or (2) charging and paying interest currently on a note that bears interest at 80 percent of the AFR.

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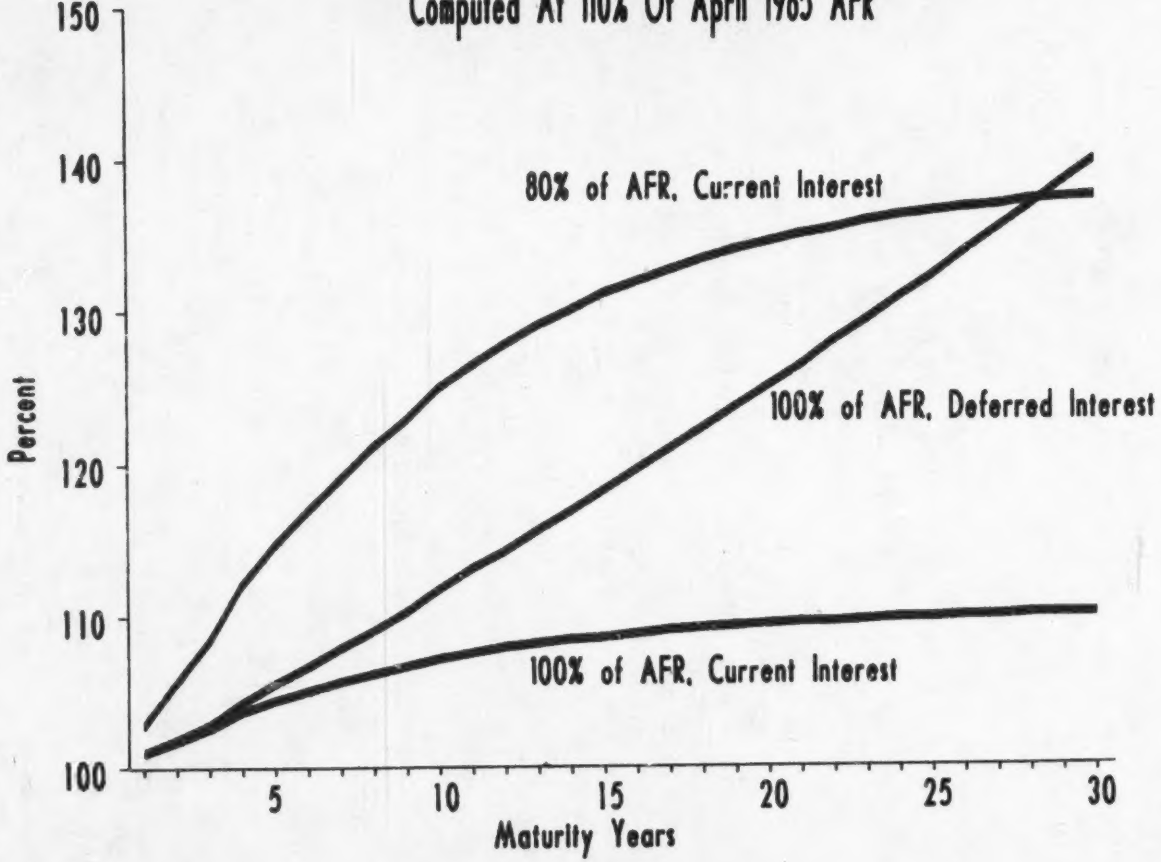
[23] In the limit, as maturity increases, the amount of overvaluation on an interest-only note at 80 percent of the AFR, relative to a similar note at 110 percent of the AFR, converges to the ratio of 110 to 80 (37.5 percent).

[24] In the limit, as maturity increases, the amount of overvaluation on an interest-only note at 100 percent of the AFR, relative to a note at 110 percent of the AFR, converges to the ratio of 110 to 100 (10.1 percent).

Stated Principal Amount As A Percent Of Principal
Computed At 110% Of April 1985 AFR



The imputed interest provisions in the 1984 Act addressed only the interest rates used for testing and imputing interest in deferred payment sales of property. However, Figure 1 shows that the more interest payments are deferred and the longer the maturity of the debt, the greater the amount of principal overstatement and the concommitant tax benefits. Conversely, the shorter the maturity of the debt and the greater the extent to which interest is paid currently, the smaller the amount of principal overstatement.

Factors relevant to establishing the proper imputed interest rate

As demonstrated in the example above, distortions in the taxation of the parties to a sale can occur if the parties had unfettered discretion to characterize deferred payments as principal or interest for tax purposes. The role of the imputed interest rules is to establish parameters for allocating payments between principal and interest. The imputed interest provisions do not affect the total amount of payments flowing from the buyer of the property to the seller. Rather, they provide that, for tax purposes, a certain minimum amount of interest will be assumed to be inherent in the transaction. If the parties fail to state interest at, or above, a specified minimum rate, then the statute imputes interest at a higher rate.[25]

The most difficult issue posed by this statutory scheme is how this minimum interest rate should be fixed. Prior to 1984, the rate was set on an ad hoc basis by the Treasury Department. The 1984 Act introduced a self-adjusting, statutory mechanism for determining the test rate that was intended to keep the rate reasonably consistent with current rates in the financial markets. Assuming that a self-adjusting mechanism is preferable to ad hoc regulatory determinations, the next issue becomes which "market" should provide the standard for comparison. Considerable controversy has arisen over this issue since the enactment of the 1984 Act.

In designing the statutory mechanism for determining the section 483 and 1274 test rates in the 1984 Act, Congress' objective was to produce a system that yielded a reasonable, conservative approximation of the rate at which a good credit risk with adequate security could borrow. Although this focus on the buyer-borrower's borrowing rate was consistent with the original legislative intent behind the enactment of section 483,[26] it has been suggested by some that the appropriate focus of the imputed interest rules is the seller's reinvestment rate. That is, the relevant inquiry is what rate of return the seller could have realized had he received cash from the buyer and invested in a security of comparable risk and maturity.

In this regard, it has also been suggested that the appropriate standard may be a rate somewhat lower than the rate at which the seller could have invested cash proceeds. It is argued that sellers of property may be willing to accept less than the rate of return they could realize on alternative investments for reasons wholly unrelated to taxes. For example, the seller may for non-tax reasons accept a below-market rate of interest in order to facilitate the sale of the property.[27]

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[25] The legislative history of section 483 suggests that the imputation rate was assumed to be the normative rate, and that the inclusion of a lower test rate (which under the original statute had to be at least one percentage point below the imputation rate) was intended as "a de minimis rule to prevent the application of this provision in those cases where interest variations are relatively minor." H.R. Rep. No. 749, 88th Cong. 1st Sess. 72 (1963).

[26] See H.R. Rep. No. 749, 88th Cong., 1st Sess. 72 (1963).

Using a seller-financing rate as the test rate would result in a minimum rate that is below the prevailing market rate at which a buyer could borrow from a third-party lender. The tax consequences for both the seller and the buyer would vary, under some circumstances dramatically, depending on whether the transaction is seller-financed or financed with third party loan. A buyer required to finance a purchase with a third-party loan at the full market rate presumably would be willing in certain circumstances to pay less for the property than if below-market seller financing were available, where the below-market financing would have resulted in a higher tax basis for the buyer and increased capital gain for the seller.[28]

Problems in developing a statutory mechanism for determining the test rate

Critics of the statute assert that the test rate established by the 1984 Act is flawed in several respects.

Overall level of the test and imputation rates

A common criticism of the 1984 Act is that the test and imputation rates are excessive relative to market interest rates. The 1984 Act established test and imputation rates, based on the AFR, to take account of varying maturities and fluctuations in market interest rates. The test rate provided in the 1984 Act was intended to be a conservative estimate of the actual market rate of interest on similar obligations issued by third-party lenders. If designed correctly, the test rate would approximate the yield on a deferred payment note if it were sold in the secondary mortgage market (i.e., the "opportunity" cost of holding the note). Table 2 shows the most recent AFR for the month of May 1985 (Rev. Rul. 85-58, 1985-18 I.R.B. 5).

Table 2.—Applicable Federal Rate for the Month of May 1985

[Annual rate]

Rate	Short-term	Mid-term	Long-term
100% of AFR	10.36	11.83	12.21
110% of AFR	11.42	13.05	13.48
120% of AFR	12.49	14.28	14.74

The test and imputation rates established by the 1984 Act can be compared with home mortgage interest rates by comparing the yield on U.S. government securities (used in the computation of the AFR) with yields on government-sponsored mortgages and mortgage-backed securities. Table 3 compares the average annual yield on fixed-rate Federal Housing Administration ("FHA") mortgages, seasoned Government National Mortgage Association ("GNMA") securities, and 10-year U.S. government bonds, over the 1972-1985 period. FHA mortgages are guaranteed by the Federal government and, consequently, yield less than otherwise comparable mortgages lacking a government guarantee. GNMA securities are backed by a pool of mortgages that are either insured by the Federal Housing Administration or guaranteed by the Veterans Administration.[29] Table 3 shows that over the period 1972-1985 (February), yields on government insured mortgages and securities backed by these mortgages have consistently exceeded the rate on government bonds of comparable maturity.[30]

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[27] This is a common marketing strategy used, for example, by homebuilders.

[28] If one assumes that a buyer assesses the value of the property in present-value terms, the extent to which payments are characterized as either principal or interest may significantly affect the value of expected tax benefits, and, accordingly the value of the property to the buyer.

Table 3.—Yield on Government Bonds and Government-Sponsored Mortgages and Mortgage-backed Securities

[In percent]

Year	10-year U.S. Govt. security	FHA [1] mortgages	Seasoned GNMAs [1] (by coupon rate)				
			6½	7¼	8.00	9½	15.00
1972	6.23	7.19	7.12		7.27		
1973	6.73	7.85	7.76		7.82		
1974	7.31	9.21	8.84		8.86		
1975	7.42	9.05	8.62		8.69		
1976	7.53	8.74	8.25	8.31	8.36		
1977	7.36	8.41		8.05	8.14		
1978	8.33	9.44		8.95	9.06		
1979	9.34	10.69		9.85	9.90		
1980	11.38	13.63		11.95	11.97		
1981	13.88	16.66			14.70	15.40	15.76
1982	13.18	16.11			14.26	14.61	15.64
1983	11.01	13.46			11.87	12.11	14.13
1984	12.45	14.28			12.97	13.32	14.31
1985 [2]	11.45	13.35			12.05	12.36	13.96
1985 [3]	11.07	13.37			11.72	12.09	13.73

[1] Yield computed assuming 12-year average maturity.

[2] January.

[3] February.

Source: Salomon Brothers, "An Analytical Record of Yields and Yield Spreads" (fifth edition).

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[29] Mortgage-backed securities generally yield less than the average interest rate on the underlying mortgages because (1) ownership of a share in a pool of mortgages is less risky than ownership of an individual mortgage, and (2) the owner of GNMA securities does not bear the costs of servicing the underlying mortgages.

[30] The yield on FHA mortgages and GNMA securities is computed assuming a 12-year average maturity. The actual maturity depends on the repayment of the underlying mortgages. Low fixed-rate mortgages in periods of rising interest rates tend to be repaid more slowly than high fixed-rate mortgages in periods of falling interest rates.

The yield on government-sponsored mortgage instruments as a percentage of the yield on 10-year government bonds is shown in Table 4.[31] The average yield on FHA mortgages has exceeded the average yield on 10-year government bonds by more than 13 percent in every year over the 1972-1985 period. The yield on GNMA securities with coupon rates ranging from 6-1/2 through 15 percent has exceeded the yield on 10-year government bonds by more than 4 percent in every year since 1972.

Table 4.—Yield on Government-Sponsored Mortgages and Mortgage-backed Securities as a Percentage of 10-year Government Bonds

[In percent]

Year	10-Year U.S. Govt. security	FHA [1] mortgages	Seasoned GNMAs [1] (by coupon rate)				
			6½	7¼	8.00	9½	15.00
1972	100	115.4	114.3		116.7		
1973	100	116.6	115.3		116.2		
1974	100	126.0	120.9		121.2		
1975	100	122.0	116.2		117.1		
1976	100	116.1	109.6	110.4	111.0		
1977	100	114.3		109.4	110.6		
1978	100	113.3		107.4	108.8		
1979	100	114.5		105.5	106.0		
1980	100	119.8		105.0	105.2		
1981	100	120.0			105.9	111.0	113.5
1982	100	122.2			108.2	110.8	118.7
1983	100	122.3			107.8	110.0	128.3
1984	100	114.7			104.2	107.0	114.9
1985 [2]	100	116.6			105.2	107.9	121.9
1985 [3]	100	120.8			105.9	109.2	124.0

[1] Yield computed assuming 12-year average maturity.

[2] January.

[3] February.

Source: Salomon Brothers, "An Analytical Record of Yields and Yield Spreads" (fifth edition).

The data in Table 4 demonstrate that the holder of a seller-financed home mortgage, even if such mortgage were guaranteed by the Federal government, would generally not be able to sell the mortgage at a price corresponding to a yield of less than 113 percent of the government bond rate, over the 1972-1985 period. This follows from the fact that the secondary market sale of FHA mortgages over the period were priced at yield in excess of 113 percent of the government bond rate.[32] Even if the seller were able to pool such mortgages and obtain Federal insurance, it is unlikely that the pool could be sold to a third party lender at a price corresponding to a yield of less than 104 percent of the government bond rate. This follows from the fact that purchasers of government-sponsored mortgage-backed GNMA securities obtained a yield of at least 104 percent of government bond rate in every year since 1972. From this evidence it does not appear that the test rate (110 percent of the AFR) does not exceed prevailing market interest rates for home mortgages.

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[31] The relative yields are computed directly from the yields shown in Table 3.

[32] Note that the secondary market yield in the sale of FHA mortgages understates the effective interest rate paid by the homebuyer since points charged by the lender are excluded.

Currentness of the Federal rate

The statutory mechanism for determining the AFR has been criticized as producing a rate which lags behind market rates during periods when interest rates are falling. This is attributable to the six-month length of the base period and the three-month period allowed for Treasury to compute and publish the Federal rates. This problem has been largely solved by the alternative system for computing the Federal rate which the Treasury Department has promulgated in temporary regulations under section 1274.

Instability of the Federal rate

Another criticism of the mechanism for determining the AFR is that the index is too volatile during periods of rapidly rising rates. The argument has been made that, when interest rates in the financial markets rise precipitously, rates in the seller-financing market do not necessarily follow immediately or rise to the same degree. It has been argued that the test rates under sections 483 and 1274 should be allowed to lag behind financial market interest rates.

If one accepts the argument that volatility is a problem under the present system (that is, that test rates should not react immediately and precisely to fluctuations in the financial markets) several alternative solutions are possible. First, the base period over which yields on Treasury securities are averaged could be lengthened from 6 months to 12 months or longer. Second, some other index besides one based on Treasury securities could be used to determine the test rate. This could be an existing index or one specially designed for this purpose. The choice of this index would be influenced to some extent by conclusions about the appropriate rationale for the test rate, that is, whether it is a borrowing or a lending rate and whether it should vary from one type of property or market to another.

Finally, some stability in rates could be achieved by including a statutory limitation on the amount the test rate can rise from one period to the next. For example, the statute might provide that, notwithstanding the rates established under the general formula, the test rate may not increase more than a specified number of percentage points over some period of time.

Most of the interest rate limitations that have been proposed reduce the rate that the interest index rises in periods of increasing rates, but do not reduce the rate that the index falls in periods of declining rates. Consequently, such interest rate limitations not only serve to reduce interest rate volatility, but also reduce the average rate of the interest index over time.

Relief from the imputed interest rules for certain transactions

If, as some critics of the statute assert, the imputed interest rules as amended by the 1984 Act are too strict in their result, two approaches are possible. First, across-the-board relief could be provided by modifying the statute to make the test rate less than 110 percent of the AFR. This could be done as an alternative to, or in conjunction with, the modifications to the index discussed above. Second, lower test rates could be provided for specified categories of transactions for which relief is considered to be appropriate because application of the general rule is particularly harsh or unduly complex, or for other reasons.

Relief based on nature of transaction (functional approach)

As discussed more completely in Section V. below, two of the Senate bills introduced this session (S. 56 and S. 71) provide a 9-percent test rate for sales of residential property up to $250,000, sales of an active business up to $1 million, and sales of farm property up to $2 million. The rationale for doing so is that sales of these types of property either fail to present the opportunity for the types of abuse that the imputed interest rules are intended to prevent, or that such sales should be spared the complexity of the 1984 Act's rules.

In addition, the stopgap legislation generally excepts from the imputed interest rules assumptions of loans in connection with transactions involving this "triad" of properties.

Relief based on size of transaction (threshold approach)

An alternative to the functional approach is to provide relief based on the dollar size of the transaction. Until July 1, 1985, the stopgap legislation provides a lower test rate for transactions not involving new investment credit property to the extent the "borrowed amount" does not exceed $2 million. Any amount in excess of this "threshold" is subject to the generally applicable test rate.

One rationale for a threshold approach is that relatively small transactions do not pose sufficient opportunities for abuse to warrant a full application of the imputed interest rules and that taxpayers engaging in such transactions should not be subject to the increased complexity of following a varying rate.

A number of issues must be resolved if a threshold approach is adopted. The first issue is whether the threshold should be based upon the size of the borrowed amount, the sales price of the property, or the total amount of the deferred payments. If the threshold is based on the borrowed amount, a decision must be made whether this includes only financing provided by the seller in the immediate transaction, or whether it also includes the amount of loans assumed (or taken subject to) by the buyer and third-party purchase money loans obtained by the buyer.

The second issue relates to when separate transactions will be aggregated for purposes applying the threshold. For example, if a single seller sells a 1/10 interest in a single property to ten different buyers, and each transaction uses the threshold amount, may the seller use the lower rate for each of the sales? What if each of ten co-owners of property sells his undivided interest in the property for the threshold amount to a single buyer? Should each seller be allowed to use the lower test rate on the entire amount of the debt, or should each get 1/10 of the threshold amount at the lower rate? How should the rule be applied in the case of property bought or sold by partnerships or other pass-through entities? Should the limitation be applied at the entity level or at the partner or beneficiary level, or both?

Finally, should the relief be available without regard to whether the taxpayer is a large public corporation or a limited partnership, on the one hand, or a relatively unsophisticated individual on the other? Should the relief be available for sales of property eligible for the investment credit, sales of property between related parties, or sale-leasebacks?

Before these issues relating to the measurement and application of the threshold can be resolved, it is necessary to determine precisely what are the objectives of relaxing the rules for transactions below the threshold. That is, which types of transactions deserve relief from the general rule and which do not?

Differences between test and imputation rate

Under section 483 as originally enacted, the imputation rate was assumed to be the normative rate. The inclusion of a lower safe harbor rate was intended to reflect a *de minimis* exception; that is, interest would not be imputed where the stated rate did not vary significantly from what was considered to be an appropriate rate.

This two-rate system, which was preserved by the 1984 Act, has been criticized as creating undue complexity and a penalty for uninformed taxpayers.

The Committee may wish to consider eliminating the imputation rate in sections 483 and 1274 and imputing interest at the test rate in cases where interest is stated at a rate below the test rate.

B. Method of Accounting

Where section 1274 applies to a transaction, the OID rules require both the seller and the buyer to account for all interest income and deductions arising from the seller-financed debt instrument as the interest accrues economically. As a result, the buyer may receive interest deductions prior to making any interest payments, and the seller may be required to include amounts in income prior to receiving any interest payments. Some seller-financed transactions, for valid nontax business reasons, provide for little or no cash payments for an initial period (e.g., the property sold may generate little or no cash flow in that period). In these circumstances, it may be argued that it is unfair to require the seller to include amounts in income prior to receiving cash.

The mandatory accrual of interest income and deduction rule is intended to prevent mismatching of interest deductions and the related interest income. Requiring both buyer and seller to account for interest income and deductions on the cash method of accounting is another possible way of preventing mismatching. Under such a "cash-cash" regime, a buyer would not receive any deductions until interest is paid, and a seller would not include any interest in income until received, regardless of their normal methods of accounting.

Nevertheless, cash-cash accounting may generate unintended benefits that would prevent effective matching of income and deductions. For example, an accrual-method seller might sell property in a transaction that provides for deferred payments and results in the deferral of the interest income under the cash method. If the seller borrows in order to finance the buyer's obligation and is able to deduct currently the interest on that borrowing, then unrelated income may be "sheltered" from tax.

Another type of transaction in which the use of cash-cash accounting may undermine the goal of effective matching of income and deductions is a seller-financed sale to a buyer for whom the deferral of interest deductions imposes little or no tax cost (e.g., a tax-exempt or foreign entity). Since deferral of deductions would not be as costly to such a buyer as current inclusion would be to the seller, the parties have an incentive to arrange for deferral of both income and deductions to reduce the effective tax cost to both parties. Moreover, such a situation can be abused easily if the buyer resells the property using wrap-around financing, thereby allowing the ultimate purchaser to take current interest deductions while allowing the original seller to defer interest income.

Rules would need to be developed, either in the statute or regulations, to prevent such unintended results and other possible abuses that could occur if cash-cash accounting is adopted for certain deferred payment transactions.[33] However, even with such rules, cash-cash accounting would not prevent mismatching as effectively as accrual-accrual accounting.

C. Assumptions

Frequently, in connection with the sale or exchange of property, the buyer will assume a debt obligation of the seller or will take the property subject to an outstanding debt obligation. Either such transaction can be considered the economic equivalent of a transaction in which the buyer gives the seller a note, (in addition to any other consideration given in the transaction), the terms of which are identical to the terms of the obligation assumed and the payments on which are used to satisfy the seller's underlying obligation.[34]

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[33] As noted in Part II, *supra*, cash-cash accounting is permitted for interest on debt instruments issued in connection with certain sales of farms prior to July 1, 1985. The Treasury Department is empowered to provide regulations that would prevent mismatching of interest income and deductions arising from the use of the cash method of accounting for such transactions.

[34] For convenience, the discussion will focus on only the assumption of a debt obligation, but is equally applicable to the taking of property subject to an existing debt. In addition, a similar issue arises in the case of so-called "wrap-around" debt. In a transaction involving wrap-around debt, the seller of property leaves the original debt on the property outstanding and takes back an increased amount of purchase money debt from the buyer. For example, a seller owns property worth $1,000 with an outstanding third-party mortgage of $500. Instead of accepting the buyer's note for $500 and having the buyer assume the mortgage, the seller takes the buyer's note for $1,000 and remains the primary obligor on the mortgage. The buyer's $1,000 note is known as a wrap-around indebtedness because it is said to be "wrapped-around" the underlying debt of the seller.

Therefore, where debt bearing interest at less than the applicable test rate is assumed in connection with the sale or exchange of property, the buyer may receive an inflated basis for the property, and the seller may convert interest income to capital gain. This result can be avoided if section 1274 or section 483 were applied to the transaction as if an economically identical transaction had occurred as described above.[35]

If the transaction were structured in this equivalent form, either section 1274 or section 483, (if no exception were applicable), would test the adequacy of interest on the buyer's note. If the assumed debt bore interest at less than the applicable section 1274 or section 483 test rate, part of the principal on the buyer's note would be recharacterized as interest.[36] Accordingly, the buyer's basis and seller's amount realized would be reduced while the buyer interest deductions and seller's interest income would be increased.

It has been argued that assumable debt relating to a parcel of real estate is inherently part of the "package" that is sold to the buyer and therefore, that no adjustment of the terms should occur for income tax purposes. In addition, a debt that is assumed was initially either third-party debt or presumably had adequate interest under the imputed interest rules in effect at the time of its creation. Nevertheless, even if the assumable debt is part of the package being sold, a sound tax policy argument may be made that the income tax consequences of the transaction should reflect indebtedness valued at fair market rates.

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[35] Except for assumptions meeting the requirements for exemption from section 1274 and 483 (see Part II, *supra*), the assumption of a debt obligation in certain circumstances is treated as the issuance of a debt instrument by the buyer to the seller and is subject to the interest recharacterization provisions of section 483. In such a situation, the third party lender would have interest income and the seller would have interest deductions arising from the assumed debt obligation as if the debt had not been assumed; the buyer's basis and interest deductions as well as the seller's amount realized and interest income would be determined by reference to the assumed debt as recharacterized. Treas. Reg. sec. 1.483-1(f)(6)(iii).

[36] An alternative method of testing the adequacy of interest on assumed obligations is to test a hypothetical note, the terms of which include payments on the assumed debt as well as any payments on seller financed debt of the buyer. If this method were used, not every assumed loan bearing interest at less than the applicable test rate would require the recharacterization of principal, since including the seller-financed debt, the buyer's entire obligation arising from the transaction may bear interest at a rate exceeding the test rate.

V. DESCRIPTION OF BILLS

A. Senate Bills

1. S. 56 (Senator Abdnor) and S. 71 (Senators Dole and Warner)

Under S. 56 and S. 71, in the case of sales of personal residences with a purchase price of less than $250,000, farms with a purchase price of less than $2 million, or active trades or businesses with a purchase price of less than $1 million, the rate for determining whether there is adequate stated interest in a transaction (the so-called "test rate") may not exceed 9 percent. Where the purchase price is higher than these specified amounts, the rate for imputing additional interest where stated interest is inadequate (the so-called "imputation rate") would be a weighted average (based on the purchase price) of the rate for transactions below the specified amount and 110 percent of the Federal rate (the "AFR") (100 percent of the Federal rate (the "AFR") for farms). In the case of property subject to these lower rates, both the buyer and the seller must account for the interest income or interest expense on the cash method of accounting.

In the case of sales of real property and tangible personal property associated with the real property, the test rate would be 80 percent of the AFR, provided the debt instrument does not have a maturity of more than 12 years (or two-thirds of the recovery period of the property, if shorter) and the total amount of deferred payments do not exceed $4 million. Interest on transactions subject to this rule would be accounted for under the cash method. In addition, transitional rules would phase in this new test rate rate from 10.5 percent to 12 percent in the period from January 1, 1985, until December 31, 1986.

The bills would provide for a test rate of 100 percent of the AFR in the case of debt instruments not meeting the requirements for the 80 percent test rate, so long as most of the interest is paid currently. However, interest income and interest deductions on transactions subject to this rule would continue to be accounted for under the accrual method of accounting. Transitional rules would phase in the 100 percent rate for transactions subject to this rule from 11 percent to 12.5 percent in the period from January 1, 1985, until December 31, 1986.

The bills also would provide for a test rate of 80 percent of the AFR in the case of sales of homes with a purchase price of less than $250,000 by a builder to home buyers. Where the purchase price exceeds $250,000, the minimum rate would be a blend of 80 percent and 100 percent of the AFR. In the case of dealers using this rule, any interest deductions on debt attributable to carrying the purchase money debt on the homes would be limited to the interest income from the purchase money debt.

In addition, S. 56 and S. 71 would provide a mechanism that limits the increase in the AFR where there are significant increases in interest rates over a relatively short period of time. Under this mechanism, where interest rates have increased by more than 2 percentage points during a six-month period, the increase in the AFR generally is limited to one-half of the increase. However, the AFR can always return to the highest level it had been in the previous two years. The bills also would provide that, where interest rates have decreased significantly, such that use of the measuring period of present law would be inappropriate, the Treasury Secretary can use a more recent measuring period.

In transactions where the sales price of the property does not exceed $100 million, S. 56 and S. 71 except assumptions of loans that were made before October 15, 1984, from the imputed interest rules and provides that, where a buyer assumes a loan made after October 15, 1984, the imputed interest rules only affect the buyer and not the seller. S. 56 and S. 71 also would provide that the AFR for the periods before January 1, 1985, is to be 10 percent and that there would be no penalty imputed rates where State usury laws prohibit the stating of interest at the test rate.

2. S. 217 (Senators Melcher and Levin)

Under S. 217, lower test and imputation rates would apply to transactions in which the borrowed amount does not exceed $2 million. The test rate for borrowed amounts up to $2 million is the lower of 9 percent or 80 percent of the AFR. If the borrowed amount were more than the $2 million threshold, then the test rate would be a weighted average or blended rate determined by applying the lower of 9 percent or 80 percent of the AFR on the amounts up to $2 million and 80 percent of the AFR on the excess.

Where inadequate interest is stated, the bill would impute interest at a rate equal to the lower of 10 percent or 100 percent of the AFR on amounts up to $2 million, and 100 percent of the AFR on any excess.

The bill would provide that in the case of loans that are assumed in a sales transaction, the imputed interest rules and the OID rules would not apply.

The bill would also repeal the provision of current law under which a cash-method borrower who uses the proceeds of the loan to purchase personal use property is denied an interest deduction in a taxable year for any amount in excess of the interest actually paid on the loan. Thus, for example, if a homebuilder sold a home to a customer under an installment sale contract stating that only principal was payable for three years, the buyer would be allowed to deduct interest under the imputed interest and original issue discount rules during those three years.

3. S. 251 (Senators Durenberger, Heinz, Zorinsky, and Boschwitz)

Under S. 251, lower test and imputation rates would apply to transactions in which the borrowed amount does not exceed $2 million. Under S. 251, the test rate for borrowed amounts up to $2 million is the lower of 9 percent or 80 percent of the AFR. If the borrowed amount were more than the $2 million threshold, then the test rate would be a weighted average or blended rate determined by applying the lower of 9 percent or 80 percent of the AFR on amounts up to $2 million and 80 percent of the AFR on the excess.

Where inadequate interest is stated, the bill would impute interest at a rate equal to the lower of 10 percent or 110 percent of the AFR on amounts up to $2 million, and 110 percent of the AFR on any excess.

The bill also provides that, in the case of loans that are assumed in a sales transaction, the imputed interest rules and the OID rules would not apply. S. 251 specifies that taking property subject to an existing debt is treated like an assumption of the debt for purposes of the exception provided for assumptions, and also clarifies that the exception only applies if the terms of the debt are not modified.

S. 251 would also repeal the provision of current law under which a cash-method borrower who uses the proceeds of the loan to purchase personal use property is denied an interest deduction in a taxable year for any amount in excess of the interest actually paid on the loan.

In addition, S. 251 would exclude from the OID rules any debt instrument issued in a sale of property to be used as a residence by the obligor. This would modify present law in two respects. First, under the 1984 Act, only transactions arising from a sale of a principal residence of the *seller* are exempt from the OID rules. Under the bill, the focus is on the use of the property by the buyer. Thus, for example, builders would not be subject to the OID rules with respect to debt received from buyers of homes. Second, the exception from the OID rules would apparently apply without regard to whether the residence was a *principal* residence. Thus, vacation and other secondary homes would presumably be covered by the exception.

4. S. 729 (Senators Durenberger, Roth, Symms, Pryor, Grassley and others)

Under S. 729, lower test and imputation rates would apply to transactions in which the borrowed amount does not exceed $4 million. The test rate for borrowed amounts up to $4 million is the lower of 9 percent or 80 percent of the AFR. If the borrowed amount were more than the $4 million threshold amount, then the test rate would be a weighted average or blended rate determined by applying the lower of 9 percent and 80 percent of the AFR on the amount up to the $4 million threshold and 80 percent of the AFR on the excess.

Where inadequate interest is stated, the bill would impute interest at a rate equal to the lower of 10 percent or 100 percent of the AFR on amounts up to $4 million, and 100 percent of the AFR on any excess.

The bill provides that, in the case of loans that are assumed in a sales transaction, the imputed interest rules and the OID rules shall not apply, and that the taking of property subject to an existing debt is treated like an assumption. The exception for assumptions does not apply if the terms of the assumed debt instrument are modified. The bill specifies that in the case of wrap-around indebtedness the imputed interest rules would only apply to the borrowed amount, exclusive of the "wrapped" (or underlying) debt, thereby treating a wrap-around debt like an assumption.

S. 729 would also repeal the provision of current law under which a cash-method borrower who uses the proceeds of the loan to purchase personal use property is denied an interest deduction in a taxable year for any amount in excess of the interest actually paid on the loan.

In addition, S. 729 would exclude from the OID rules any debt instrument issued in a sale of property to be used as a residence by the obligor. This would modify present law in two respects. First, under the 1984 Act, only transactions arising from a sale of a principal residence of the *seller* are exempt from the OID rules. Under the bill, the focus is on the use of the property by the buyer. Thus, for example, builders would not be subject to the OID rules with respect to debt received from buyers of homes. Second, the exception from the OID rules would apparently apply without regard to whether the residence was a *principal* residence. Thus, vacation and other secondary homes would presumably be covered by the exception.

B. H.R. 2475 as Reported by the Committee on Ways and Means

On May 14, 1985, the House Committee on Ways and Means reported a bill, H.R. 2475 (H.R. Rep. No. 99-87), to revise the present law imputed interest rules. The bill also would extend the ACRS cost recovery period for real property (other than low-income housing) from 18 years to 19 years.

1. Imputed interest rules

H.R. 2475 would provide that the test rate on the first $2 million of seller financing is the lower of 9 percent or 100 percent of the AFR. Where the amount of seller financing is greater than $4 million, the test rate is 100 percent of the AFR. Where the amount of seller financing is between $2 million and $4 million, that rate is a weighted average or blend of the lower of 9 percent or 100 percent of the AFR on an amount which begins at $2 million and which phases out on a dollar-for-dollar basis as the amount of seller financing exceeds $2 million, and 100 percent of the AFR on the excess. The $2 million and $4 million threshold amounts are indexed for inflation after 1988.

H.R. 2475 would also provide that the imputation rate is to be the same as the test rate (i.e., there would be no higher penalty rate where inadequate interest is stated). In addition, the Federal rates are to be determined on a monthly basis, and a rate for a month may be used for sales or exchanges occurring in that month and the next two succeeding months. The imputed interest rules would not apply to assumed loans.

Further, in certain transactions where the amount of seller financing is not more than $2 million, H.R. 2475 would allow the parties to elect to account for interest in the transaction on the cash method of accounting. The election cannot be made if the seller is a dealer in the property sold or uses the accrual method of accounting.

The amendments by H.R. 2475 to the imputed interest rules would apply to sales and exchanges after June 30, 1985.

2. ACRS recovery period for real property

H.R. 2475 would extend the ACRS recovery period for real property (other than low-income housing) from 18 years to 19 years. This change generally would be effective for property placed in service after May 8, 1985. However, the longer recovery period would not apply to property placed in service after May 8, 1985, and before January 1, 1987, if the taxpayer had entered into a binding contract to purchase or construct the property before May 9, 1985, or construction of the property was begun by or for the taxpayer before May 9, 1985.

STATEMENT OF SENATOR DOLE

Mr. CHAIRMAN. I have just a short statement to make at this point. The imputed interest-original issue discount controversy should have been resolved last fall. We had a compromise solution drafted, agreed to by all the major associations representing affected businesses except the large syndicators, and passed by the Senate. Unfortunately, the House was unwilling to accept anything more than a temporary solution which expires June 30.

We are, therefore, in the unenviable position of having to address the issue again. As my colleagues know, in January I reintroduced the Senate-passed measure as a starting point for action this year. That legislation is complicated, as any compromise is likely to be. But it reflects the basic concepts that I would hope a permanent solution would include. It minimizes the impact on residential housing, small businesses, and farmers who, more likely than not, do not have tax avoidance as a primary motivation. On the other hand, it conforms the tax laws to economic reality for the larger transactions where the parties are sophisticated enough to make full use of any tax advantage arising where the law does not reflect the true value of money.

Because the Senate-passed legislation conforms to the goal of targeting the new rules to the deals with the greatest opportunity for abuse, It loses very little revenue compared to the rules included in the Deficit Reduction Act of 1984.

Mr. Chairman, we could undoubtedly agree on legislation which would be consistent with the goal of targeting the rules to the transactions with the most potential for abuse without the complexity of S. 71. However, I hope that we will not allow simplicity to be an excuse for failing to address the potential abuses which led to the enactment of the Deficit Reduction Act's imputed interest and original issue discount changes in the first place.

STATEMENT OF SENATOR GEORGE J. MITCHELL

Mr. Chairman, I am pleased this hearing has been called today to review the temporary imputed interest rate rules that are scheduled to expire on July 1, 1985.

This is a complex area of the law that requires delicate legislative treatment. On the one hand Congress must write specific rules to apply to a variety of transactions that can be arranged to avoid tax liability in deferred payment sales of property. This requires establishing complicated new definitions that recharacterize owner financed property sales according to the true economics of the transaction.

On the other hand, these rules must not be so cumbersome and strict as to interfere with the market place during periods of high interest rates.

Homeowners, farmers and small businessmen are often forced to provide financing in order to sell property when interest rates are high. It is imperative that exceptions be carved out for these small transactions and I expect the Committee will establish appropriate rules to address this issue.

We must decide what transactions legitimately should fall within the exceptions to the rule on the basis of size or potential for abuse. Beyond that, there are a number of technical questions dealing with loan assumptions and wraparound financing.

The 1984 tax bill will have effectively eliminated the most abusive transactions. That battle has been won and we must now fine tune the law to free up the marketplace for legitimate transactions. It is my hope that we can move expeditiously to establish reasonable and permanent rules for imputing interest.

Senator CHAFEE. Good morning. Today, the subcommittee will examine the imputed interest rule to the Tax Code, which as we all know is extremely complicated. These rules restrict the ability of taxpayers to understate the real interest costs involved in the sale of homes, farms, and businesses. They generally apply when interest payments are deferred or below-market interest rates are charged. In the Deficit Reduction Act of 1984, Congress adopted modifications to the tax treatment of imputed interest, designed to account more properly for the time value of money. First, the act provided that the amount of imputed interest would henceforth be determined not by a fixed rate set by the Treasury Department, but by an interest rate tied to the yields on U.S. Treasury obligations. In other words, it wasn't a static figure—it was movable. Second, the 1984 act expanded the rules dealing with original issue discount to cover many deferred payment obligations arising from the sale of property The purpose of this change was to ensure that interest deductions taken by the buyer during a given year did not exceed the interest income reported by the seller during that year. Concerns were expressed that these rules could have a harsh impact. In October of last year, the Congress responded to these concerns by enacting legislation that would apply prior law to transactions in which the loan amounts involved were less than $2 million. This relief expires July 1, 1985, and we are here today to discuss alternative suggestions for making the rule permanent. Imputed interest is not a new concept. It was incorporated in the Tax Code in 1964 to ensure that adequate interest was charged on transactions. I agree with the purpose underlying the modifications adopted last year. Those modifications were designed to correct the abuses which have arisen in which sophisticated tax planners could manipulate interest rates in order to inflate the value of property and enjoy overstated tax benefits. They are also designed to prevent the mismatch of deductions and income recognition resulting from transactions between accrual-based and cash-based taxpayers, using deferred interest obligations to purchase property. While it is important to correct such abuses, I believe it is also important to develop a mechanism to exempt small transactions from these complex rules. We look forward to hearing the testimony from the witnesses who have come to discuss this complex matter today. I am delighted that Senator Wallop is here. Do you have a statement, Senator?

Senator WALLOP. Mr. Chairman, I don't have a formal one, but I note with interest the comment that imputed interest is not a new concept. That still doesn't make it a good concept. I have a hard time with the idea of the United States Government entering into private business transactions and saying what is and is not an adequate business dealing. I have no objection to the efforts to try to tie together a mismatch of deductions for interest charged and interest received. There is something really weird about a Government that ties imputed interest rates to the yields of the Treasury that would have fixed that. The concept is sort of pervasive in this whole thing, and it basically says that the only rate of interest in the land that is adequate to make business deals on this is that which the Government manages to have to pay. And if we tie our business deals to the way the Government runs its business, I think that the country is in desperate condition. In my State, and it has been in part dealt with by the amendments of last, there are a lot of old business institutions—old hotels, guest ranches, and other kinds of things—and the only means by which they could be sold is by attracting a buyer with a less than market rate of interest. The Government's interest in that seems to me to be negligible because it really is the question of whether one man with a property can dispose of it by any means available to him. And there is a pervasive attitude that is brought on by making a blanket judgment that because some abuse it, all abuse it. I would rather find the means. I know it is difficult to go after the ones who do abuse it than to assume that everybody who charges a rate of interest that is less than market is, in fact, out to defraud the Government, who may in fact be only out to survive in the world of tough economics.

Senator **CHAFEE**. Thank you very much, Senator, and I have a statement here from a member of this committee. Senator Durenberger, which he asked that I read, and which I will briefly do so.

STATEMENT OF SENATOR DURENBERGER

I would like to thank Senator Chafee and Senator Packwood for holding this hearing on the imputed interest problem. I regret that I had a previous commitment and am unable to attend. I recognize that with the major tax reform debate currently taking place and the President's tax proposal coming next week, the imputed interest question has a tendency to get lost in the background. However, we need to address this issue before the temporary provision expires on July 1. S. 729 has broad bipartisan support and is a simple, effective solution that all parties who work with these rules can live with, and I am hopeful that S. 729 can be the basis for solving the problem. I welcome this hearing and any comments upon the bill as a first step in the legislative process that will lead to a resolution. I ask that the remainder of my statement be included as part of the hearing record.

And that will be done. We will give you that statement. All right. We are delighted to have two of our distinguished colleagues lead off. Gentlemen, why don't you both come to the table? Senator Melcher from Montana and Senator Howard Metzenbaum from the State of Ohio. Gentlemen, we welcome you here. Senator Melcher, why don't you lead off?

STATEMENT OF HON. JOHN MELCHER, U.S. SENATOR FROM THE STATE OF MONTANA

Senator **MELCHER**. Mr. Chairman, I am very pleased that these hearings are being held so that Congress will enact permanent legislation to correct this serious and capricious problem of tax policy on imputed interest rates. The present provisions involve holding off until July 1 implementing the drastic requirements on taxing income on seller-financed transactions of real estate. These requirements would probably eliminate most of these types of sales. The Ways and Means Committee in the House of Representatives has reported out legislation modifying the imputed interest rate law that was set in the 1984 Tax Act. I feel that the legislation drafted by the Ways and Means Committee takes most of the necessary steps to correct the problems in the 1984 Tax Act regarding imputed interest on seller-financed sales. The House Ways and Means Committee bill exempts sales of real property with a debt of less than $2 million from any new higher imputed interest rates. It also recognizes that the required imputed interest rate in the 1984 Tax Act of 110 percent of applicable Federal rates [AFR] is too high for larger sales and sets the rate at 100 percent of AFR. Finally, it recognizes that loan assumptions should not be affected by changes made in the law subsequent to June of 1984. I believe that most people who wish to use seller financing can live with the provisions of the Ways and Means Committee legislation. However, there is one area of the Ways and Means Committee proposal that I believe could be improved. I believe that it is more equitable for seller financers to permit the interest rate for the first $2 million of debt to be blended with that above, rather than requiring that sales over $4 million be subject totally to the 100 percent AFR rate. I would hope that we could convince Chairman Rostenkowski and the House Ways and Means Committee members to move in this direction, and it has been my suggestion that language could be added to ensure that we protect against abusive transactions in larger sales in return for acceptance of a blended interest rate. But the most important point is that we need to complete action on these modifications to the imputed interest rate law before the expiration on July 1 of the temporary moratorium now in place. I believe that the best way to ensure timely action is to try to pass legislation in the Senate and the House of Representatives that is very similar in order to avoid the possibility of a long, drawn-out conference between the two Houses. We have the opportunity to find a workable solution that is acceptable to both the Senate and the House, and I hope this can be accomplished. Mr. Chairman, I do not intend to reiterate here the history of my long involvement, starting in 1979, in the imputed interest rate question. I discussed that in some detail before the committee last August. It is time now to get the problem of imputed interest rates behind us. Second, I believe there is a legitimate role for seller financing in the real estate market. In many areas of the country, including my State of Montana, up to 80 percent of real estate transactions involve some seller financing. Provisions such as those in the 1984 Tax Act which effectively eliminate seller-financed sales of real estate as a viable option to commercial financing will, if not corrected, add one more burden to our already-stagnant economy. We can pass simple, easily understood legislation that will eliminate tax abusive transactions while permitting legitimate seller-financed transactions to take place. We should move quickly to do that, and I will do everything I can to assist the Finance Committee in its efforts to get this job done prior to July 1. That is the end of my testimony.

Senator CHAFEE. Thank you very much, Senator. Are you free to stay for a few minutes?

Senator MELCHER. Yes, I am.

Senator CHAFEE. I thought we might hear the statement of Senator Metzenbaum and then I have a couple of questions I would like to ask you. Senator Metzenbaum? We are delighted to have you here, and why don't you proceed?

[Senator Melcher's prepared statement follows:]

Senator John Melcher's Testimony
on Imputed Interest Legislation
Before the Senate Finance Committee
May 20, 1985

Mr. Chairman, I am very pleased that these hearings are being held so that Congress will enact permanent legislation to correct the serious problem of tax policy on imputed interest rates. The present provisions in the law hold off until July 1 implementing drastic requirements on taxing income on seller-financed transactions of real estate. Those requirements would probably eliminate most of these types of sales.

The Ways and Means Committee in the House of Representatives has reported out legislation modifying the imputed interest rate law that was set in the 1984 Tax Act. I feel that the legislation drafted by the Ways and Means Committee takes most of the necessary steps to correct the problems in the

1984 Tax Act regarding imputed interest on seller-financed sales.

The House Ways and Means Committee bill exempts sales of real property with a debt of less than $2 million from any new higher imputed interest rates. It also recognizes that the required imputed interest rate in the 1984 Tax Act of 110 percent of applicable federal rates ("AFR") is too high for larger sales and sets the rate at 100 percent of AFR. Finally, it recognizes that loan assumptions should not be affected by changes made in the law subsequent to June of 1984.

I believe that most people who wish to use seller financing can live with the provisions of the Ways and Means Committee legislation; however, there is one area of the Ways and Means Committee proposal that I believe could be improved. I believe that it is more equitable for seller-financers to permit the interest rate for the first $2 million of debt to be blended with that above, rather than requiring sales over $4 million to be subject totally to the 100 percent AFR rate. I would hope that we could convince Chairman Rostenkowski and the House Ways and Means Committee Members to move in this direction, and it has been suggested that language could be added to ensure that we protect against abusive transactions in larger sales in return for acceptance of a blended interest rate.

The most important point is that we need to complete action on these modifications to the imputed interest rate law before the expiration on July 1 of the temporary moratorium now in place. I believe that the best way to ensure timely action is to try to pass legislation in the Senate and the House of Representatives that is very similar, in order to avoid the possibility of a long, drawn-out conference between the two

Houses. We have the opportunity to find a workable solution that is acceptable to both the Senate and the House, and I hope that this can be accomplished.

Mr. Chairman, I do not intend to reiterate here the history of my long involvement, going back to 1979, in the imputed interest rate question. I discussed that in some detail before the Committee last August.

It is time to get the problem of imputed interest rates behind us. Secondly, I believe there is a legitimate role for seller financing in the real estate market. In many areas of the country, including my state of Montana, up to 80 percent of real estate transactions involve some seller financing. Provisions such as those in the 1984 Tax Act which effectively eliminate seller-financed sales of real estate as a viable option to commercial financing will, if not corrected, add one more burden to our already stagnant economy. We can pass simple, easily understood legislation that will eliminate tax abusive transactions while permitting legitimate seller-financed transactions to take place. We should move quickly to do that, and I will do everything that I can to assist the Finance Committee in its efforts to get this job done prior to July 1.

STATEMENT OF HON. HOWARD M. METZENBAUM, U.S. SENATOR FROM THE STATE OF OHIO

Senator **Metzenbaum**. I am happy to be here, Mr. Chairman, and I commend you for holding this hearing this morning. It is not a new subject to the Senate, or to the Congress. It is not a new subject to me. It is a subject that we legislated and debated on the floor of the Senate when the June 29, 1984 enrolling error resolution was up for passage and again in October 1984. Since that time, I am frank to say, I have heard nothing from the real estate lobby until last week when we did have some discussions on the subject. And now it is a fact that we are pressing for time because July 1 is closer than many of us care to think about. So, I think that we have to understand what this issue is all about and not kid ourselves. We are not talking about the seller-financed transactions that our distinguished colleague from Montana is talking about. What we are really talking about are those real estate deals where you push up the price and lower the interest rate in order to create a higher depreciation allowance for the buyer and to transform ordinary interest income into preferential capital gains. Now, when I was growing up, Mr. Chairman, I was told that the fiercest thing in the world was a mother defending her young. Until I came to the Senate, I believed that. No more. [Laughter.]

Because here in the Senate, I have witnessed special interest lobbyists defend their tax breaks with a ferocity that would put a lioness mother or a grizzly bear to shame. We saw that, for example, in the bank lobby's campaign against withholding on interest and dividend income. Thousands and thousands of letters from people wrongly informed that this was a new tax. Now, it is the turn of the realtors, and they have churned up and really gotten their members all excited on the issue. It is the third time in the past 11 months that the so-called aggrieved realtors of this country are here to seek relief from a responsible action of the Congress. On June 27, 1984, this body adopted a conference report on the Deficit Reduction Act of 1984, which included a provision designed to prevent tax avoidance in seller-financed transactions—the so-called imputed interest rule. On June 29, we passed that which was misnamed an enrolling error corrections resolution. It was no more an enrolling error correction than the man in the Moon, but the purpose of it was to exempt the first $250,000 of the price of a principal residence and farm sales of up to $1 million from the higher imputed interest rates. It was substantive legislation, not an enrolling error. That still wasn't good enough, in spite of the fact that we had sort of jiggered the rules in order to put through that enrolling error correction for the real estate lobby. So, in October 1984, we enacted a temporary measure to exempt all transactions up to $2 million from the higher imputed interest rates. That measure expires at the end of next month. And the theory was that immediately—at least some of us thought—that immediately after the October passage, there would develop a series of negotiations and discussions to see whether or not we could come up with a piece of legislation that was reasonable and did not affect adversely Federal income. Now, the real estate lobby is back. We have taken care of principal residences. We have taken care of small farmers. And now they want us to take care of what they call "small business." How? By exempting from the higher interest rates in the 1984 bill seller-financed transactions of up to $4 million. Now, what kind of transactions are these? Are these really these small deals they are talking about? What we are talking about in the main are transactions involving existing structures, not new properties—existing structures that are being sold as tax shelters. Now, if they are new properties, at least you can make the argument that you are doing that in order to help the economy, in order to provide more jobs. We are not talking about those kinds of deals. There may be one in 10. There may be one in 20. But what we are talking about are the churning the selling and reselling, of shopping centers and office buildings and industrial parks and so on. And what we are talking about is the real estate lobby—just as every other lobby that comes here—who says to us: Gentlemen and ladies of the U.S. Senate, you have an obligation to balance the budget. At the same time they are saying: Yes, but be sure to take care of us—we don't count—we are a special kind of interest—we are entitled to some special kind of treatment because of this, that, or something else. Now, why subsidize such transactions? These transactions don't create new investments, new buildings, new jobs. Why subsidize this churning which everyone knows is a reality of life. I have two deals here on my desk. I am not sure exactly what impact the present legislation would have on it. Here was a shopping center that sold for $15,500,000, but you are permitted to take depreciation based on $23,500,000 or $8 million more than the sales price. And it requires how much cash? Only $1 million cash investment with the rest nonrecourse debt. And then Morgan Stanley, a very prestigious house on Wall Street, has here a deal where you can invest $100,000—$100,000 for equipment—but you receive ACRS deduction and tax credits based on $671,350. Now, I am aware of the fact that there may be some argument as to whether these particular transactions could continue under the proposed legislation—but the point that I am making is that these are typical of the kinds of transactions that are being sold in this country. Mr. Chairman, I believe that it would be responsible for Congress to retain the 9-percent interest rate on the sale of all homes. I think that would not have an adverse impact upon the realty market. I think it would be good for the country. I think it would be good for that segment of the real estate industry that sells homes. And I think that that would make sense. I also believe that the first $1 million in farm sales should have the 9-percent interest rate applicable, regardless of the full sales price. And I further believe that the 9-percent rate should apply to a modest amount of commercial real estate sales for small businesses with limitations on how much any individual taxpayer could sell or finance at the more favorable levels in a given year. In other words, I think that our legislation ought to direct itself at providing a limited amount of relief for any one taxpayer. I think the major syndicators should not be given relief. I don't think there is any economic or political or logical justification for it. I do not think that they have a case to make for any relief whatsoever, and I certainly don't believe that you can make out a case with respect to the Durenberger bill which would cost the Federal Treasury $1,800,000,000 over the next 5 years. I don't think that the Federal budget can afford that. I don't think the country can afford it, and I don't believe that is warranted. I am prepared, Mr. Chairman—and I am not a member of this committee, but I certainly have a strong interest in this issue—to try to work this issue out. But I believe that there is a sense of urgency about it because July 1 is closer than many would think, and I would hate to have this become a major issue again on the floor of the Senate. I hope we can avoid that. I thank you, Mr. Chairman.

Senator CHAFEE. Thank you very much, Senator. Under your proposal, would you go back to the 9-percent rate for all individual residential sales? I was looking in the New York Times yesterday and I saw some of those residences are selling for what seemed to be a fairly substantial amounts—in other words, in the $1 million plus range. This isn't somebody in Schenectady buying a house for $110,000. These are people on Long Island buying very, very fancy residences and they are not exactly innocents. Would you let them get the 9 percent?

Senator METZENBAUM. If the committee felt that there should be some limit, I would certainly find no objection to that, but my feeling is that one of the reasons that I would have less difficulty with having no limit with respect to homes, is that they are not properties that are by-and-large being sold for depreciation purposes. And you have two sides to this coin. One is the question of lowering the interest rate, to transform ordinary money into capital gains and the other is raising the price so that you get higher depreciation. When you get the higher depreciation, it has that much greater negative impact upon the Federal Treasury.

Senator CHAFEE. I will be asking Mr. Pearlman that very question, that is whether we need to worry about all of this when, we are not dealing with depreciable property. Senator Melcher, in your testimony, you cited on page 4 what seemed to me to be an astonishing statistic. You said 80 percent of the real estate transactions in your State involved some seller financing. Did you mean commercial real estate or all real estate, including residential real estate?

Senator MELCHER. I mean commercial land and homes.

Senator CHAFEE. You mean everything?

Senator MELCHER. Everything.

Senator **Chafee**. It seems so high. Was that in a particular year? Some of the statistics we have from the National Association of Realtors show nationally in 1982 the figures were something like 40 percent of homes were seller financed, which astonished me; 1982 was a year of especially high interest rates, and maybe to encourage sales there was more seller financing than usual. Is this rather typical in your State? The figures run as high as 80 percent regardless of the year?

Senator **Melcher**. Yes; it is, and when you ask—I am not just singling out homes and saying they are 80 percent. I am saying all the sales, if you add them all up, and no realtor. Well, realtors are not involved in all sales, but IRS wants to be involved in all sales.

Senator **Chafee**. Yes; fine. Now, Senator Wallop, do you have any questions?

Senator **Wallop**. No, Mr. Chairman; I just have an observation. I think Senator Metzenbaum's statement is more an argument for tax reform and less an argument for tax meddling. I really see what you are trying to do is put the Government in the middle of a situation in which it has no business. If it is, in fact, an obligation that is incurred, the best way to do that is to write a tax bill with treatment of interest that doesn't favor the wealthy, and the only way you can do that is to get yourself down to one level rate because the higher the rate of personal taxation, the less the impact of interest is on that individual. But for Treasury or Congress or anybody else to waft figures out of the air and say what is and is not legitimate in terms of interest concept is just totally foreign to me. I don't have a problem with what you say troubles you, but I have a problem with the approach to it. I just don't see that that works.

Senator **Metzenbaum**. I would not disagree with what my colleague from Wyoming is saying—that it is not the proper function of Government to intervene, but we do so often. We say what the minimum wage should be in this country. We say when you have to pay time and a half for overtime. We do have tax laws that make this kind of situation necessary. If there weren't the tax laws providing for accelerated depreciation and for capital gains, you wouldn't be involved in this kind of an issue. And so, if we were totally out of the picture, I would agree completely, but we are already there. Now, whether or not we get tax reform and whether or not something comes out of this Congress on that subject is something neither you nor I can predict with any real accuracy, but if we are going to play with these laws—and we are called upon to do something by July 1—then I think that we have to see to it that we are evenhanded and that we particularly have to see to it that it doesn't adversely affect the Treasury's income.

Senator **Wallop**. My problem is, one, the assumption that this money first belongs to the Treasury. The second is that it isn't a situation of tax equity, but quite the opposite. What you are doing by all of these approaches—not you specifically, but we in the Government and any of the ones who are proposing it—is bashing the legitimate guy as well as the ones who create complex business deals. And I have a problem with that because there are some of these deals which are totally legitimate and totally at arm's length and totally the only means by which two people with property and an interest in it or a business of any dimension—whether it is real property or otherwise—can get together. And when those people do that and within their rights and within the laws of the country, it seems crazy to me because some other people abuse it to abuse them. I mean, I just don't like the idea of generalizations about business deals, and this is the biggest generalization about business that I know of in the Tax Code.

Senator **Metzenbaum**. Wouldn't you agree, Senator, that to put $1 million into a real estate transaction and have a writeoff of $23.5 million and only pay $15.5 million for that property deserves the attention of Congress, or otherwise the transaction——

Senator **Wallop**. But that is not a problem of imputed interest. That is a problem of the Tax Code in general. And that is where I come apart on the thing, you know. I don't quarrel with you about that end result. I just quarrel with you that this is the wrong dog to kill.

Senator **Metzenbaum**. Senator, I have indicated previously I have no problem about some farmer in Montana selling his property at a lower interest rate so that he can make the transaction. That one really doesn't bother me. What does bother me is the Treasury getting taken by those investment bankers who put together these deals and they are structured in such a way to give you much more tax writeoff than actually the total amount of the investment. And I believe that Congress has an obligation, if we are sincere in our effort to balance the budget and to be fair and equitable, I believe we have an obligation to do something about it.

Senator **Wallop**. I don't quarrel with you, but I think you are in the wrong. Again, the assumption is that—the one you are making—is that all dogs bite and therefore we kill all dogs. I just don't think you are onto the right dog here. I mean, you have got too many of them.

Senator **Metzenbaum**. Right. I have indicated both in my testimony today and on the floor of the U.S. Senate previously that I was prepared to make those distinctions. We, indeed, did make a distinction when Senator Melcher—if my recollection serves me right—I think it was you who came forward with a $1 million exemption for farm property. And that is my recollection. I think that is how we got to it. And the $250,000 on residences. That also came about by our trying to work out something, but no matter what you give the real estate lobby, they want a little bit more.

Senator **Wallop**. I might say I haven't heard a soul in the real estate industry come and talk to me, and that is perhaps because I just find this whole concept offensive.

Senator **Melcher**. Mr. Chairman, there is one point that ought to stick in our minds, and that is if it is a depreciation question, that in itself has no depreciation, so that cannot be the loophole that allows for some gouging. Furthermore, there is a great number of people who must keep in mind that there are more small businesses, and more farms and ranches going on the block simply because of the economic situation for the producers. They just can't make it, and a large number are having to shove their property—whether it is a farm or ranch or the small business in the farm community—the farmer-ranch community—that have to shove their property on the selling block. And there is not a host of willing buyers, and you are not going to find them in the Morgan-Stanley proposals. You are not going to find them there at all, but if they are going to sell them, they are going to have to have seller-financed contracts—the contract for deed—or they won't be sold at all. And that usually means—that usually signals—a lower rate of interest. Furthermore, if the rates of interest are going to come down, and I hope they do, we simply do not need to trigger something at 110 percent of Treasury rate while it is declining because that becomes a further abuse to common sense and a further blockage of the seller-financed sale. I can see hobgoblins at night in my dreams, but I think there have been too many hobgoblins posed on this imputed interest rate question. I think as long as we have some mechanism where you are talking about something below $4 million, we are not creating the rate on the Treasury. As a matter of fact, I don't know how the Treasury can lose anything because, if we allow the present law to stand, there won't be any seller-financed sales, and therefore, Treasury can't collect anything, the IRS can stay at home and not have to look into so many people's private transactions.

Senator CHAFEE. I would point out that the Federal Government is in this not just because the Federal Government wants to be snooping, but because these transactions are treated differently for tax purposes. There is a different rate for a capital gain than there is for ordinary income, and thus, it makes a lot of difference. If we try to achieve some equity in the Tax Code and try to have people pay their taxes, there is a real reason for saying that people can't just willy-nilly select whether something can be capital gain when normally it would be ordinary income. There is a whole code written on that. That is one of the reasons we are here.

Let me ask Senator Melcher. On the blending that you talk about, doesn't that pose some complications? What is your theory? As I understand it, you would blend the rates for loans over $2 million up to $4 million?

Senator MELCHER. That is right. If the exemption is for $2 million and the 9 percent rate is available, then if it had to be 10½, or the transaction because it was above $2 million and allow the blending of the 9 on the first $2 million and the higher rate on that above $2 million. So, it would be a blended rate. And I think I get this over the hurdle of the sale of property that is $2.1 million, $2.2 million, and so on.

Senator CHAFEE. You are afraid of the so-called cliff effect?

Senator MELCHER. That is right.

Senator CHAFEE. As I understood from your statement, you believe that the threshold level in the House bill; namely, the exemption for debt less than $2 million from the higher imputed interest rates, is appropriate?

Senator MELCHER. I do.

Senator CHAFEE. All right, fine. Gentlemen, we thank you very much for the benefit of your advice here, and now we will hear from Mr. Pearlman, Assistant Secretary of the Treasury for Tax Policy.

Senator METZENBAUM. Thank you, Mr. Chairman.

STATEMENT OF HON. RONALD A. PEARLMAN, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Secretary **PEARLMAN**. Good morning, Mr. Chairman. We are pleased to be here this morning to work with the subcommittee in reexamining the imputed interest matter.

Senator **CHAFEE**. Have you got any of your people with you?

Secretary **PEARLMAN**. I sure do.

Senator **CHAFEE**. I am always glad to meet them. Why don't they come forward?

Secretary **PEARLMAN**. I will be happy to introduce you.

Senator **CHAFEE**. Why don't you bring them up to the table, and then we will all know who they are?

Secretary **PEARLMAN**. That is fine. Let me introduce Jeffrey Quinn, who is a member of our Tax Legislative Counsel staff, and David Garlock, who is one of our Associated Tax Legislative Counsels, and I would be happy to let you lodge your criticisms to them instead of me. [Laughter.]

Senator **CHAFEE**. Go ahead.

Secretary **PEARLMAN**. Mr. Chairman, we believe—and maybe we will have an opportunity to discuss this a bit more after my statement—that the 1984 act did in fact develop rules, articulated rules, that provided for the proper tax treatment of deferred payments in sale and exchange transactions involving property. Nevertheless, as was true in the very early stages of this legislative process when the administration put forward some proposals in the imputed interest and original issue discount rule area, we recognized and continue to recognize that we have to have some rules for small transactions that are simple, easy to administer, easy to understand for people who do not have the benefit of sophisticated tax advice. It is well, I think, to return to the problems that existed before 1984. They came up in your discussion with Senators Melcher and Metzenbaum, and I want to emphasize those now because I think we all, in designing these rules, have to be mindful of these problems. They are threefold:

First, basis overstatement. Second, the conversion by a seller of interest income into capital gain, or in the case of residences, the conversion of interest income into gain which may never be taxed because of the special rules we provide for taxation of gain on the sale of residences. And third, the deferral of interest income and the acceleration of interest expense depending on the mismatch of the seller's and buyer's methods of accounting.

Prior to 1984, the original issue discount rules which deal with parts of these three problems were not applicable to obligations that were issued either by individuals or issued in exchange for the sale of nonpublicly traded property. So, by not being applicable to real estate or nonpublicly traded personal property, the absence of the original issue discount rules permitted the mismatch of interest expense and interest income, and that produced significant tax sheltering activity which we brought to the Congress' attention at that time.

The written statement contains a rather simple example of one transaction involving the deferred payment sale of property, in which a $5 million obligation is taken back at 12.5 percent interest compounded annually and payable in a lump sum after 20 years. An accrual method obligor in the 50-percent bracket would take on a present-value basis interest deductions totaling $5.6 million. At the same time, a cash method seller would defer all of that interest income. When you work out the numbers, what we find is that the revenue loss to the Treasury—again on a present-value basis—was $3.3 million in a $5 million transaction. If you go through that same analysis in a $20 million transaction, the revenue loss just from one transaction rises to over $13 million. We also suggested in connection with the 1984 legislation and Congress responded that we needed some adjustment to section 483. The imputed interest rule prior to the 1984 act gave Treasury Department the authority to prescribe a stated interest rate—a 9-percent rate had been prescribed for a number of years. A 6-percent rate was prescribed in certain circumstances, and those rates had stayed in effect really without regard to fluctuating market rates.

Efforts by the Treasury Department to make those rates more accurate were met with opposition, both within the private sector and from Members of Congress. By understating interest, the consequence is the overstatement of principal, and that has two effects—the conversion of interest income into either capital gain or nontaxable gain and the overstatement of basis which produces an acceleration of depreciation deductions and an increase in the investment tax credit if the sale of personal property is involved. The 1984 act sought to correct these problems, and I think it is fair to say that, in general, these problems are corrected by the 1984 act.

Immediately, concerns were raised with respect to small transactions and in Public Law 98-612 Congress responded by creating a very broad safe harbor for small transactions, providing a 9 percent stated rate for transactions where the financing was up to $2 million.

Senator **Chafee**. I must say I must come from the wrong part of the country. If a small transaction is $2 million, that is amazing. It opens my eyes. Where I come from, $2 million looks like a fairly substantial amount of money. We classify that as a big transaction.

Secretary **Pearlman**. Mr. Chairman, in the part of the country I came from, $2 million was fairly substantial as well. Nevertheless, I think there is some benefit in overstating a small transaction threshold. I am not personally concerned that the number be $200,000 or $1 million. I would observe in this regard, however, that we have always felt that it was much more important if we are going to define small transactions to talk in terms of the transaction, that is how much is being paid, whether it is on a cash or deferred payment basis in the sale of the property. That is not, frankly, the way that people who want to liberalize these rules further have sought to do it. Rather, the suggestions, and it is true of the bills that are pending in the Senate, is to look at the amount of debt involved.

So, you could have transactions involving very substantial amounts of sale price which I would presume all of us would agree would not be small transactions—$50 million transactions—in which there would be a great benefit for a portion of that transaction if the debt is smaller than, let's say, $2 million or $4 million, whatever the threshold.

So, while I think it is always going to be a matter of differences of view as to what really is a small transaction, we set much lower thresholds in the original legislative proposals that the President came forward with. I do think it is helpful to think in terms of the aggregate amount of the transaction, rather than simply the aggregate amount of the debt in ultimately defining the amount of the exemption.

There are several bills, as I know you are aware, that have been introduced this year in the Senate to amend the imputed interest and OID rules. These bills, which I am not going to go into in detail, provide a variety of changes from the transitional rule that was adopted on a short-term basis last year by the Congress. They deal with providing a lower test rate, a lower imputation rate. They provide exceptions for residences, farms, and small businesses. They provide a different threshold level—a couple of these at the $4 million level. They provide, in some instances, a significantly lower threshold than a 9 percent fixed threshold rate is.

What I would like to do in my limited time this morning, Mr. Chairman, is simply to offer to you certain considerations that we think should be kept in mind in fashioning rules for small transactions. And let me say again that we are supportive of the effort of trying to design some rules which will generally meet the concerns that are being expressed in transactions which fall more likely on the small end of the spectrum than on the large end. The first, of course, is the definition of small transaction. I believe what we should be concerned with here is the burden of planning that is imposed on taxpayers as a result of the 1984 act, and that burden obviously falls heaviest on small transactions. They should be defined and in a manner to include those where the parties are not as sophisticated, where it is reasonable to assume that they are not as familiar with the tax rules, and further reasonable to assume that they will not receive the kind of tax advice that is to be expected in larger transactions.

Now, we suggested looking at a transaction size with a purchase price—not a debt amount, but a purchase price—of $2 million or less. That is an appropriate threshold for defining a small transaction. There has been a great deal of pressure to look instead at the amount of debt, as I mentioned a moment ago, and if the subcommittee determines that it prefers to look at the amount of debt involved in the transaction, then we believe the threshold should be a smaller amount.

Senator CHAFEE. What is it now under the temporary legislation? Is it based on debt or is it based on sale price?

Secretary PEARLMAN. It is based on debt; $2 million based on debt.

Senator CHAFEE. So, you could have a vastly larger transaction in terms of sale price.

Secretary PEARLMAN. Certainly, that is the case. It really depends on how the entire rule is fashioned. One approach is the approach that the House took in its response, and that is to put an upper limit on that safe harbor debt, so that you get the most favorable interest rate below $2 million. And then between $2 million and $4 million under the House proposal, you get a blended rate. And then over $4 million, you get no benefit.

Senator CHAFEE. But always talking debt?

Secretary PEARLMAN. In that case, always talking debt. Yes. But even in that case we are talking about the potential of a very substantial transaction. Again, take my $50 million transaction which has $3 or $4 million of debt, getting a benefit from these provisions, which we suggest is really not appropriate if you are really going to look at small transactions.

Senator CHAFEE. So, what are you saying? You should change that to sale price?

Secretary PEARLMAN. Our suggestion is that we think that we—we leave to Congress the judgment as to what the amount should be, but we think if you are going to talk about the size of the transaction in terms of the sophistication of the taxpayer and the complexity of the rules, then it would seem to me you have to look at the size of the transaction, not simply the amount of the debt. So, one problem obviously is the definition of small transaction, and our points there have been discussed. The second one is the danger, the risk, maybe it is better to say the problem that is involved once we define a transaction as a small transaction. It forces us to make distinctions between small and large transactions. And that is going to create problems. Let me give you an example of one of the simplest ones—the problem of developing rules that deal with aggregation. That is, if you have a small transaction rule that says $1 million or $2 million, then you have to make sure the taxpayers aren't able to take five of those transactions and put them together in what we would all agree is a single transaction and claim the small exemption. So, it is necessary to design rules that permit taxpayers to use the small transaction rule but in a way that does not abuse the purpose of that rule. The third item that I think the subcommittee has to focus on is whether the test rate in the small transaction category should be fixed or fluctuating. Both have been suggested. We think that the only sensible thing to do is to use a fixed rate, and we think it is desirable to have a mechanism whereby that fixed rate can be adjusted as rates vary—as actual market rates vary. But we think that the strong argument—and it is a strong argument—is that in small transactions people should be entitled to rely on a known interest rate. They shouldn't have to go out looking for what a current market rate is or a fluctuating rate. Then, the only sensible way to bring that certainty to those transactions is to use a fixed rate. So, our suggestion is for the use of a fixed rate, and indeed we think that a 9-percent rate for the transactions below the threshold would be an appropriate fixed rate.

Several of the Senate bills provide a cash accounting election in lieu of the original discount rules. The concept here would be one in which both parties to the transaction—purchaser and seller—could elect to use the cash method of accounting, and the theory behind that proposal is that the cash method is simpler and in small transactions it is just easier for taxpayers to use the cash method. We are not terribly excited frankly about the cash method election. I will get to that in a moment. But I think in considering whether in fact a cash method election is appropriate, it is important to recognize and for all of us to remember that original issue discount is only relevant when the taxpayers are not paying interest currently. Let's assume, for example, in a small transaction setting that we have a 9 percent fixed interest rate. The vast majority of taxpayers are going to pay that interest currently, and if they do the original issue discount rules are irrelevant and method of accounting is not important. It is only in those situations where interest is being deferred, and that is not the common transaction in our judgment. It is only in those situations that some adjustment—that the original issue discount rules become potentially applicable, and some adjustment is being suggested in a small transaction context. Now, the reason we have problems with a cash method election, or so-called cash-cash election as it has been known, is the level of complexity. Once we put into the system an optional two methods of accounting, then we are going to raise the prospect of what happens in transactions, in which either the encumbered property which is the subject of the original transaction is sold and the obligation is assumed, or the obligation in that original transaction is sold. And in both situations, we will be asking ourselves how is the assignee of the obligation or the purchaser of the property who assumes the debt to be treated if a cash-cash election had been made by the original parties to the transaction. Now, those questions can be answered. The important thing is if you go down that road of saying a cash-cash election is appropriate in small transactions, I think we all have to recognize that that brings with it complexity and that those questions are going to be raised and we will have to seek to answer them. Our recommendation is that because most transactions will involve the current payment of interest, and if we set that interest rate at an appropriate safe harbor rate such as 9 percent, that most parties of the transaction are not going to be involved in the application of the original issue discount rules. Interest is going to be paid currently, and in that instance we think that it is not necessary, and I would suggest perhaps not even appropriate, that there be a relaxation of the original issue discount transactions. A couple of other points that I want to mention. First, we think that, to the extent you do create a safe harbor for small transactions, it be limited to casual sales and not the sales by dealers. If we extend these rules to dealers, we get into the aggregation problem that I mentioned a moment ago, and it becomes even more important. And in addition, I would suggest to you that dealers don't have the problem of not being aware of the rules, of being unsophisticated, that the seller of a residence or the seller of a farm might have. So, we think it is not wise to extend these safe harbors to people who are dealers in the sale of this property. Next, the question has come up——

Senator CHAFEE. I am not sure what a dealer is.

Secretary PEARLMAN. Someone who is in the business of selling homes, for example. Someone who subdivides real estate and sells the parcels.

Senator CHAFEE. I see.

Secretary PEARLMAN. We don't think—the dealer is defined, and it is generally defined as someone whose sale of the property—activity in terms of the sale of the property—is in the ordinary course of business and not the casual sales of property. And in those transactions, I think that the problem of the complexity of a rule, of knowing what market interest rate for example is, or applying the original issue discount rules if sales are on a deferred payment basis are simply not the same as those——

Senator **Chafee**. Now, I have trouble understanding that the people are going to be mousetrapped by these rules when they are dealing with $1 million or $2 million sales. It seems to me in those instances that most people would consult a lawyer when they are selling something for $2 million, particularly real estate. Is there something happening out there that I am not aware of? Do people step up and sell $2 million of property by just standing outside the barn door? Do they just whittle a stick and swap and sell for $2 million?

Secretary **Pearlman**. I think that in general transactions of that level are going to receive some kind of advice—legal or accounting advice—but I think it is probably also true that there are going to be sales of farms, for example, in which that level of advice is not available to the taxpayer. So, I think that there is some merit in articulating a threshold that is large enough to take care of those kinds of transactions involving small businesses which could go up into the hundreds of thousands of dollars involving farmland in which perhaps the level of sophistication of the parties is not as high as we might otherwise expect. But obviously, when you set a threshold like that, there are also going to be a good number of transactions in the $1 million and $2 million levels where there is very sophisticated tax advice in which the tax rules will be taken advantage of.

Senator **Wallop**. Mr. Chairman, I just can't resist stepping in here with a sense of minimal outrage. You know, my goodness sakes, I know of transactions in agriculture as you suggest, Mr. Pearlman, where people have made that arrangement between neighbors. I think, in my own view, that that is rather more sophisticated than less, damn it. Who says you have to have a lawyer and accountant to tell you what is a good deal, when two people who arrive at one? I mean, this is really offensive when you start measuring the sophistication of taxpayers. When I was little, we used to measure the sophistication of Indians. We used to call them competent and noncompetent Indians. And a competent Indian could do his own work, and a noncompetent Indian had to go to the Government. Are we going to get to the place in the Treasury code where somebody has to lay out the sophistication of a taxpayer? And whose measurement is going to call it sophisticated?

Secretary **Pearlman**. Senator, I think I completely agree with you. I think that parties can deal in a very sophisticated manner, and they sure don't need advisors to help them, but what we do find—and what the criticism that is being made here by people—and what I mean when I say sophisticated—is that those two people that you just described that did their sale of the farm without consulting with anyone, may not be aware of the tax rules. They may not be aware of original issue discount rules. They may not be aware of interest rates. And that is the criticism that is being lodged here, and I think it is a legitimate criticism.

Senator **Chafee**. I know, but the other side of the coin was that when people are dealing with $2 million pieces of property, the chances are pretty good that they know something and they have heard of the Internal Revenue Code.

Senator **Wallop**. This may be the one instance where you would wish to have your Government call you a yokel. [Laughter.]

I mean, in essence, there is just something really foul about this distinction.

Senator **Chafee**. No, but the point that we are trying to get across here is that there are very serious tax consequences—avoidance or evasion—avoidance under the present rules—that come about or can come about under the system that now exists. It isn't just a bunch of innocents. Under one system, it counts as ordinary income. Under another system, it is capital gain. That makes a difference to the Treasury.

Senator **Wallop**. And it makes a difference to the two people doing business as well, and they have a right in this country to conduct business so long as it is legal. The problem doesn't lie with imputing interest. The problem lies with the rest of the Tax Code. What we are doing with this whole concept is entering into transactions that are perfectly legitimate between people who are sophisticated or not sophisticated, and I just can't tell you how wrong I think this is. If you have a problem, this isn't it.

Senator **Chafee**. I just can't tell you how wrong I think it is that some people can hire high-powered accountants to work out a system whereby they don't pay any taxes.

Senator **Wallop**. OK. So, it is OK then if they don't have the accountants and they are not sophisticated.

Secretary **Pearlman**. Senator, let me try a different approach. Let's take your transaction. Let's say we have a piece of farmland, and you are talking about $1 million. The buyer and seller sit down. They don't know anything about the tax rules, and the buyer makes an offer of $1 million, and the seller says he wants more than that. He wants $1.5 million. The buyer says I will only pay you $1 million, but what I will do is I will pay you a higher interest rate, or conversely—you can flip it either way. Let's do it again. Let's assume $1 million is the real price, and the seller wants $1 million, and the buyer says I will pay you $0.5 million but I will pay you a higher interest rate. The seller says no, I would rather have the $1 million, but I will take a lower interest rate. Well, buyers and sellers are smart. They understand what the difference of that is. So, I am not talking tax difference. Buyers and sellers understand. Sellers understand that if they get $1 million, there is a difference whether they sell that property and get a 7- or 8- or 9-percent interest from the purchaser, or whether they get $1 million in cash and take it down to a hopefully solvent bank or savings and loan and get 11 or 12 percent interest. People understand that, and my judgment is that taxpayers are very sophisticated, even in small residence sales. I believe people really understand that when they make sales and when they make purchases. A buyer understands that if he can pay a seller a 10-percent interest rate but go to a savings and loan and it costs him 14 percent, that is not a bad deal. It seems to me that the right answer is from a nontax standpoint that we can let the buyer and seller make those decisions any way he wants to make them. And we shouldn't interfere with that, but when it comes to how those transactions are characterized for Federal income tax purposes, where it does make a difference, where whether it is interest or not is significant, whether it goes into basis or not is significant, whether it is capital gains or ordinary income is significant—then it does seem to me that it is quite appropriate for the tax rules to articulate distinctions and that that is not an interference, in my judgment, in the private decisionmaking process. That is simply a recognition that once parties make a deal—that the tax system has to come in. If we are going to set a preferential tax rate for capital gains, then there have to be rules that say when is an item a capital gain and when isn't it. I prefer to look at these rules not solely as taxable interest rules. We know there are significant taxable items involved in both the characterization of income and in the timing of interest deduction and in interest income, but there is more to it than that. And it is simply the proper characterization of what parties determine between them. And we do that all over the tax system. As long as we make distinctions in the tax system between kinds of deductions and kinds of income, it seems to me we are going to have to continue to have those kinds of rules.

Senator WALLOP. Mr. Pearlman, in your paper here, you go through a transaction for $1 million where somebody took less than the stated rate of interest. And your statement is that, therefore, the property was not worth $1 million. Isn't the business deal worth what two people can come up to on it? I mean, you are saying that in every instance the Government has a right to make a judgment as to whether these two people were correct in their assessment of how the deal fit them. That is how you bargain in the world, and it just doesn't seem to me any legitimate role of Government to come in there and say that's not a good deal—that probably wasn't worth $1 million, but only $880,000 because of the rate of interest that you are charging.

Secretary PEARLMAN. Senator, I think the problem here is the fact that buyers and sellers in these transactions are performing two functions. The buyer is performing the function of the purchaser of the property, but he is also performing in the function of a lender—excuse me, of a borrower from the seller. If we split those two transactions and if a buyer and seller acting on a cash basis with no financing involved—no seller financing involved—if they made a deal as to what the value of that property was and it was reflected in the sale price, I think you are completely right. The Government has no right to come in and say that transaction is some different price. That is, if the buyer goes down to the bank and he borrows the purchase price and he pays whatever the market rate for that debt is, I don't think we have a problem. The problem here is not questioning the good faith, if you will, of the buyer and seller, even in the routine transaction, but the fact that we are merging two transactions in a single transaction and that buyers and sellers are thinking not only of the purchaser and seller of the property, but they are also thinking as borrower and lender. And they don't have to make that distinction. They can just say we are going to sell the property for $1 million. But for tax purposes, we are constrained to make that distinction and recognize that there are two transactions going on.

Senator WALLOP. But in truth, wouldn't you say that they are constrained by certain other things like economic reality? I mean, not very many people walk around with $1 million in their hip pocket. And that is a level of sophistication we haven't reached. But you come up to it—you say they are merging two transactions into one. I would tell you that, according to the third one—I mean the way Treasury is approaching it—you are merging two into three, and the third one is the grace of Treasury, which tells you what you may and may not keep according to a sophistication level and judgment, according to certain other kinds of concepts that are devised in Washington, not on the ground where people are making those. That is my problem with it. I understand your problem. I think it is, as you were saying, you are not getting enough money. I am not certain that under the circumstances of the Tax Code as it is written that is yours to begin with. We as taxpayers do not, I think, keep what we keep by grace of the Treasury. Treasury gets what it gets by grace of the Congress and the good will of the people. It is the attitude of this that is troubling to me, not the consequences. I think the consequences are that you have a lousy Tax Code, and you are fixing it up to make it worse. You are really making it endlessly more complicated where people have to make sophisticated judgments as to the competence or noncompetence of the people in the transaction, of the circumstances of the economy as it exists in the area. For example, the part of Wyoming in which I live is endlessly more depressed than some other parts of Wyoming. You would make a totally different deal in Sheridan, WY, today than you would in Gillette, WY, today because it is just totally different. And I have a problem with Treasury or Congress coming in and saying that both those have to be viewed the same regardless. And that is where I think we are. I understand what you are saying. You think that and know that there are transactions that are totally devised around the Tax Code. That is true. There are also other ones that are totally devised around economic reality, and they are being lumped into the same box. And I don't think that it behooves this country to write the Tax Code or any other portion of our legislation as though all of us were murderers, as though all of us were capable of deviousness, because some of us are. And that is the problem that I have with this whole concept as it is laid down and the solution to it and the resolution of the original solution.

Senator Chafee. What would your solution be?

Senator Wallop. My solution is really to do what is being suggested in at least two of the tax reform packages. I don't know what yours is going to be. I certainly hope you have an easier way of dealing with this when that is recommended. Mr. Chairman, it is the wrong thing for us to do to get ourselves in the middle of these kinds of judgments. It has to do with the overall treatment of interest, the overall rates of taxation on business and individuals, much more than it does with this kind of computation of whether or not throughout the country, the entire economy is on a level basis at any given moment in time. I have a problem with this floating rate, where I make a deal with somebody now that is totally within your concept of what is acceptable. Assume that I can do that today, and then assume that in 5 years or 8 years the interest rates have risen significantly, and that floating rate—now all of a sudden I don't have a good deal any more, and that is a problem that I think is not very legitimate either.

Secretary **Pearlman**. Senator, let me just point out that that is not a problem, even under current law. The rate does float until you make your deal, so you have to use the current rate. In fact, there is some leeway so that you can rely on a rate for a defined amount of time, but once you have made your deal, that is a 5-year deal of a 20-year deal, whatever the parties have locked into as the rate, under current law it is 110 percent if it is above the stopgap, then that is good for the remainder of the term. The deal will never be penalized, notwithstanding what happens with——

Senator **Wallop**. Assume the other then. Assume that you have made a deal at 14 percent and the rates come down to 10. Aren't you then just sort of causing a turning in the market?

Secretary **Pearlman**. Oh, I think that the problem you would have in a deal like that is really not a nontax deal. I think you are right. If you make a deal at 14 percent for perfectly sound economic reasons—in fact, let's assume that you borrow the money from a bank so that you don't get into these issues—then as rates go down, you will have transactions refinanced. But I don't think it is the tax rule that would drive that. I think the economy will drive that. Let me also make one other point that I think is important. I hope that we don't think in terms of Treasury versus the Congress in this exercise, and I am perfectly——

Senator **Wallop**. I don't. I think it is Treasury and the Congress versus the people in this one.

Secretary **Pearlman**. The reason I think we sit here and say we think small transaction rules are appropriate is for many of the reasons that you mentioned because we think we can develop a set of rules that will take care of the transactions we are particularly concerned about and minimize the interference with the smaller transactions that I think you are concerned about and where we share a concern. It is unfortunate that you have to have rules like this at all. I agree with that. It is the consequence, however, of a tax system that does give preference for interest expense and for capital gains and for the fact that transactions in this country—even fairly small transactions—have gotten significantly more sophisticated over the last number of years.

Senator **Chafee**. Why don't we continue with your testimony?

Secretary **Pearlman**. Mr. Chairman, I am going to try to continue very quickly because I recognize that you have others you want to hear from. Let me just mention to you that one of the key issues that will be before the subcommittee is the rate or the measure of what the stated rate should be, and there have been recommendations that that rate should be anywhere from a flat 9 percent to 80 percent of the applicable Federal rate up to current law, 110 percent of the applicable Federal rate. I am not going to go through the materials that are attached to the statement in great detail, but let me just direct you briefly to the four charts that are appended to the statement, and simply for your own information and for that of the staff, point out that we have done an analysis of both long- and short-term interest rates compared to the applicable Federal rate that is used to measure the long- and short-term rate. In Chart 1, it is just the private and the Government long-term rates compared. FHA has used as the private rate. And in Chart 2——

Senator **Chafee**. What defines long-term?

Secretary **Pearlman**. Long-term for this purpose is an average of 10 to 30 years securities, Mr. Chairman. Then, Chart 2 then takes that long-term Government rate and takes it up to 110 percent, so it approximates 110 percent of the applicable Federal rate, which is the current law rate. And in both of these charts, I think what you will find is that in no instance is the private rate below either the historic long-term rate or 110 percent of that rate, and that is true on the short-term basis, which is Charts 3 and 4, as well as the long-term basis. For that reason, we think that 110 percent does accurately reflect what is likely to be the market rate in the private sector. A number of the bills before the committee would lower the test rate to as low as 80 percent of the applicable Federal rate.

Senator **Chafee**. Mr. Pearlman, on your first two charts, is the FHA meant to indicate private?

Secretary **Pearlman**. These are private borrowing in which the FHA has done a guarantee of the debt, which would suggest that the rates are even lower——

Senator **Chafee**. In other words, in your charts here, the Government is obviously the Government, the FHA is so-called private. Correct?

Secretary **Pearlman**. Correct. That is private.

Senator **Chafee**. And your point is that the private rate is really about a point and a half above the Government?

Secretary **Pearlman**. Yes, and I would simply point out that FHA borrowing is typically going to be somewhat less than conventional loans because there is an FHA guarantee, but it was dated and it was readily available to us, and that is why we used it.

Senator **Chafee**. Yes. I thought it was kind of easy, or the private rate would be even higher.

Secretary **Pearlman**. Right. If you look at the short-term rate and you look at prime, which is a good standard for short-term rates, you will find that the spreads in many instances are very much greater. I guess, frankly, Mr. Chairman, what we are concerned about at this point is where the subcommittee might come out in terms of a measure from the applicable Federal rate, and the concern we have principally focuses on the recommendations and suggestions of a couple of bills before the subcommittee that suggest an 80-percent rate. Let me just indicate to you that——

Senator **Chafee**. Eighty percent of?

Secretary **Pearlman**. Eighty percent of the applicable Federal rate, which is much, much less than what is shown on these charts. I would just make two observations with respect to an 80 percent rate. No. 1 is that there would be a significant revenue loss that would result as compared to current law if the test rate would go to 80 percent of the applicable Federal rate. Let me also emphasize that going to 80 percent of the applicable Federal rate would permit substantial overstatements of basis. Our estimate is 30 percent of basis overstatement under sort of a current rate scenario. The tax implications of that are described in some greater detail in our statement. I am not going to get into that, but let me just indicate that would have a major impact on the current taxation of these transactions. One of the other issues that I would——

Senator **Chafee**. Now, the House took 100 percent?

Secretary **Pearlman**. That is correct. That is correct.

Senator **Chafee**. That is delightful if you can borrow 100 percent at Government rates.

Secretary **Pearlman**. It is even more delightful if you can borrow at 80, and that is why I want to emphasize the 80. I am particularly concerned with an 80 percent rate, but I think that is right. People don't borrow in this country, even prime borrowers, at the rate that our most preferred borrower borrows, and that is why we think 110 percent is an appropriate level. One of the big issues is: Should there be a phaseout of that favorable rate for the so-called small transaction? The House addressed that issue through a phaseout or a blend of a rate between the levels of $2 and $4 million. Not only does a blend or phaseout create problems of complexity, and if we are trying to deal with small transactions—and I think that should be foremost in our minds—but, in addition, taking a favorable interest rate above $2 million, as the House did, or above $1 million, which is our suggestion if you want to look at financing, raises questions as to whether you are still looking at small transactions—when you start talking about transactions of the $3 and $4 million levels.

For those people who argue that not having a blend creates a cliff, we have tried to suggest in our statement that there really isn't a cliff, that there is a relationship between the fair market value of the property and the interest rate charged by a seller, but we have not been very successful, very frankly, in persuading the private sector that there really isn't a cliff. And we believe that is a correct economic analysis to the extent the subcommittee chooses to deal with the problem of a perceived cliff by trading some kind of blending mechanism and we just offer our help in trying to do that. It does introduce significant complexity into the calculation, but we are obviously willing to try to help. There have also been strong——

Senator **Chafee**. I don't see how you can say there is not a cliff. Any time you have dramatic changes so that anything above point A becomes suddenly subjected to a higher interest rate, or whatever it might be, without blending, there is a cliff.

Secretary **Pearlman**. At least, let me make my pitch to you. Let me draw you——

Senator **Chafee**. Can you write your pitch to me?

Secretary **Pearlman**. Yes; it is written to you on page 15.

Senator **Chafee**. On page 15? All right. We will try to understand it.

Secretary **Pearlman**. OK. The final thing I want to mention is the very difficult issue of assumption of existing debt. There are all kinds of approaches that are being suggested as to how to deal with the subject of assumptions in seller financing. So, that we don't have to go into great detail this morning, let me simply suggest to you that our recommendation is that the subcommittee try to develop some rules which are referred to in the written statement as antiabuse rules, whereby we can deal with the abusive situations involving assumption of debt, but yet which will also permit transactions that do not involve abuse to proceed on a more normal course. Let me emphasize in this regard that we are very concerned about how the debt assumption rules could impact wraparound indebtedness, and we would want to emphasize to the subcommittee that whatever is done here to relieve the burden of the imputed interest original issue discount rules in certain assumption transactions not be used as an indirect way to permit people who have engaged in wraparound transactions—so-called wraparound debt transactions—to avoid gain on the sale of property.

Senator **Symms**. Could you explain what a wraparound means?

Secretary **Pearlman**. Sure.

Senator **Chafee**. Now, we are in for a long session, I can see.

Secretary **Pearlman**. Let me see if I can do it very quickly. I sold a piece of property to you, and I took back some debt. Now, you own the property and you owe me some money. You decide to sell that property to someone else. If you sell that property to someone else and that party assumes that debt to me, then you have immediate gain on that transaction, under current tax law. So, instead, what you might decide to do is enter into a new debt—leave our debt outstanding—and enter into a new debt between you and your purchaser and let that debt, as it is paid, service the funds to satisfy your debt to me. When that transaction is put together, we say—because of the way it is designed—that the debt you owe me is wrapped around the transaction that you entered into with your purchaser. And what we want to make sure of in that transaction is that when you sell that transaction and you cleverly avoid having my debt assumed that you do not avoid gain recognition because we think that is the wrong answer and that that has nothing to do with imputation of interest or original issue discount.

Mr. Chairman, I am sorry that I took as much time as I did. I appreciate your giving us the time to express our views. We do, in spite of the fact that I was put in an unusual position, I think, for Treasury in my discussions with Senator Wallop seriously believe that there is a need to develop some rules for small transactions—however defined by the subcommittee—and we are seriously interested in trying to work with you in fashioning rules that are not only going to try to produce the results that will make people generally happy, but that will produce results that are workable results, that are administrable by the Service, and are understandable by taxpayers, which I think is very important in this area. Thank you.

Senator **Chafee**. Thank you, Mr. Pearlman.

[Assistant Secretary Pearlman's prepared statement follows:]

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STATEMENT OF
RONALD A. PEARLMAN
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Treasury Department on the application of the imputed interest and original issue discount ("OID") rules to seller-financed sales of property. We are pleased to participate in the Subcommittee's reexamination of these provisions in light of the expiration at the end of June of temporary rules contained in P.L. 98-612.

The Tax Reform Act of 1984 (the "1984 Act") refined the imputed interest rules of prior law to require that taxpayers (i) determine whether adequate interest is stated in a contract for the sale of property by testing against interest rates which more closely approximate market interest rates, and (ii) allocate interest (including imputed interest) to the periods to which it relates and take the interest into account for that period. Taken together, these changes provide for the proper economic treatment of deferred payment obligations arising in connection with the sale or exchange of property. The new rules will largely prevent the abuses which arose prior to the 1984 Act, including mismatching of income and deduction, overstatement of tax basis and investment tax credit ("ITC") and accelerated cost recovery system ("ACRS") allowances and the conversion of ordinary income into capital gain taxed on a deferred basis.

Although the Treasury Department believes the 1984 Act rules provide the proper tax treatment for sales and exchanges of property, we support efforts to provide simpler rules for "small" transactions. In view of the expiration of the temporary rules contained in P.L. 98-612, I will discuss the application of the imputed interest and OID rules to transactions involving relatively small amounts. I will then address certain improvements that we believe can be made in these rules for larger transactions. Finally, I will comment on the rules relating to transactions where an existing debt obligation is assumed or property is taken subject to an obligation.

I

BACKGROUND

Congress substantially modified the imputed interest and OID rules in the 1984 Act. As this Subcommittee considers the appropriate permanent rules for seller-financed sales of property, it is important to review both the prior law rules and the reasons for the 1984 Act amendments.

1. Rules Prior to the 1984 Act

Beginning in 1969, holders of publicly-traded discount obligations or obligations issued for publicly traded property were required to include and issuers were able to deduct OID over the term of the obligation, without regard to whether the parties were on the cash or accrual method for other items of income and deduction. This treatment of original issue discount is based on two premises. First, the rules recognize that original issue discount represents interest that will accrue, but not be paid currently during the term of the obligation; this deferral is the economic equivalent of the borrower paying the interest which accrues currently with additional funds borrowed from the lender. Second, the requirement that the issuer and holder of an original issue discount obligation report original discount obligation on the accrual method ensures consistent accounting. Without such a rule, the parties could mismatch income and deductions.

The prior law OID rules, however, did not apply to obligations issued by individuals or to obligations issued in exchange for non-publicly traded property. Thus, transactions involving the purchase of real estate or non-publicly traded personal property in which there was seller financing were outside the scope of the original issue discount rules even if the financing permitted interest to accrue without being paid currently.

Deferred payment obligations issued in exchange for non-publicly traded property, including obligations issued by individuals, however, were subject to section 483. Section 483 required the parties to state a minimum rate of interest (under prior law, 9 percent simple interest) or interest would be imputed at a higher rate (10 percent compounded semiannually). Section 483 provided a maximum test rate of 6 percent and an imputation rate of 7 percent for related party real estate transactions involving $500,000 or less.

2. Reasons for Change

Limited Scope of OID Rules

Under prior law, the OID rules did not apply to deferred interest obligations issued in connection with the purchase of real estate or non-publicly traded personal property (such as machinery), or to such obligations issued by individuals. In these situations, tax avoidance opportunities resulted from the fact that interest would accrue each year, but would not be paid until maturity. The issuer of the obligation, if using the accrual method of accounting, could claim annual interest deductions while cash method holders deferred inclusion of the discount until maturity.

The ability to mismatch income and deductions for OID formed the basis for numerous real estate and other tax shelter offerings. The revenue loss from these tax shelter offerings was significant and increasing dramatically as this structuring technique became known and used widely in transactions involving seller-financing. An example illustrates the magnitude of the revenue loss from a typical transaction: A $5 million obligation bearing interest at 12.5 percent, compounded annually, and payable in a lump sum after 20 years is exchanged for property. An accrual method obligor in the 50 percent tax bracket would claim interest deductions over the term of the obligation having a present value of $5.6 million. Because the cash method obligee would defer recognition of interest income until maturity, the present value of the tax paid by the obligee in the 50 percent tax bracket is $2.3 million. Thus, the revenue loss from one $5 million transaction from the mismatching of interest income and deduction is approximately $3.3 million on a present value basis. Of course, for larger transactions, the revenue loss would be proportionately larger (*e.g.*, $13.1 million for a $20 million transaction).

In addition to the asymmetrical treatment of issuers and holders, discount bonds issued in tax shelter transactions of the type described above frequently embodied a noneconomic computation of interest (*i.e.*, simple interest payable on a deferred basis). Reporting interest on a simple interest basis accelerates interest deductions by ignoring the compounding of interest on deferred but unpaid interest; thus, interest is not properly allocated to the period in which it actually accrues. Cash method holders of the obligations are, of course, indifferent to those timing concerns because they defer inclusion until maturity. Although the use of noneconomic interest calculations was largely proscribed by Rev. Rul. 83-84, 1983-1 C.B. 97, we understand that several tax shelter offerings made prior to the 1984 Act took positions inconsistent with this ruling.

Deficiencies of Section 483

The tax law provides for different treatment of interest and principal of debt obligations given in exchange for property. In addition, other tax consequences flow from the characterization of payments as either interest or principal, such as the seller's amount realized and the buyer's tax basis in the acquired property. Section 483 was originally enacted to ensure that parties properly characterized as interest or principal amounts paid pursuant to obligations given in exchange for property.

Without interest imputation rules such as those provided in section 483, whenever a debt obligation is given in exchange for property, the parties would have the flexibility to adjust the rate of interest charged and the principal amount of the obligation so as to produce an optimal tax result without altering the underlying economic transaction. If these distortions were permitted, a seller could convert ordinary interest income into capital gain (taxable on a deferred basis under the installment sale rules) or gain that might be deferred indefinitely where a residence is sold. In the case of a buyer, the tax basis of the acquired asset would be overstated and excess ACRS allowances and ITC would be claimed.

An overstatement of principal and understatement of interest may also occur, and often does occur, even when the parties are not purposefully attempting to avoid taxes. For example, suppose a taxpayer has a piece of property which he genuinely believes is worth $1 million. He wishes to sell the property at this price but is unable to find a willing buyer. In order to move the property, the taxpayer decides (for nontax reasons) not to lower the purchase price but to offer seller financing at a below-market rate for a portion of the purchase price. This enables the taxpayer to close the sale transaction.

In this situation, the fact that the seller had to offer below-market financing to sell the property indicates that the property was not worth $1 million. Thus, even if tax avoidance was not the goal of either party to the sale, the seller has converted ordinary interest income into capital gain and the buyer has obtained an overstated basis.

This tax advantage is never available where a third-party lender finances the purchase of property (unless the seller makes a payment to the lender to "buy down" the buyer's interest rate). In such cases, the interest rate for the borrowing and the purchase price for the property are independently fixed at arm's length.

Historically, the section 483 test rates have been adjusted only infrequently, and have often been at rates considerably below market interest rates. To the extent that the test rate provided under section 483 is less than a market rate of interest, the buyer and seller may improperly characterize a portion of deferred payments as principal and understate their tax liability. Thus, a below-market test rate effectively provides a tax subsidy for seller-financed sales of property.

Prior to the 1984 Act, we became aware of a substantial -- and rapidly increasing -- number of transactions that exploited the below-market interest test rate and the noneconomic simple interest computation provided under section 483. In one case brought to our attention, a tax basis of more than five times the established fair market value of the property was claimed. Under a proper economic analysis, the "excess basis" -- i.e., the amounts payable under the obligation in excess of the fair market value of the acquired property -- represents interest and should be deductible only as it accrues over the life of the obligation. However, by virtue of the defective operation of section 483, taxpayers claimed that the excess was transformed into inflated ITC and ACRS allowances which had a materially higher present value than the interest deductions.

3. 1984 Act Changes

These abuses prompted the Treasury Department to propose a number of changes to section 483 and the OID rules. Congress adopted these proposed changes as part of the 1984 Act.

Section 1274

For transactions involving deferred payments for the sale of non-publicly traded property, the 1984 Act establishes safe harbor interest rates based on the term of the obligation to test whether the obligation states adequate interest. If the parties to a sale or exchange of non-publicly traded property involving deferred payments fail to state adequate interest, interest is imputed at a higher rate. The safe harbor test rate is 110 percent of the "applicable Federal rate" and the rate at which interest is imputed is 120 percent of the applicable Federal rate. The applicable Federal rates ("AFR") are based on average market yields on outstanding Treasury obligations of comparable maturity. The Treasury is to determine the rates for Treasury obligations with maturities of 3 years or less (the "Federal short-term rate"), over 3 years but less than 9 years (the "Federal mid-term rate") and over 9 years (the "Federal long-term rate").

The 1984 Act also expands the scope of the OID rules. After December 31, 1984, obligations issued by individuals and obligations issued for non-publicly traded property which provide for deferred interest or which fail to state adequate interest are subject to the OID rules.

The section 1274 rules embody two concepts: (i) a test rate designed to approximate a market rate of interest and (ii) OID rules requiring the parties to take into account, on the accrual method, imputed interest (where adequate interest is not stated) or stated interest (where adequate interest is stated, but is not paid currently).

In recognition that the new rules impose a greater degree of complexity than the prior law rules, Congress provided several exceptions for routine transactions and transactions not involving large amounts of money. Thus, sales of principal residences, certain sales of farms for less than $1 million and any sales involving total payments of $250,000 or less are not subject to section 1274.

Changes to Section 483

The application of section 483 was limited to deferred payment transactions involving sales or exchanges of property falling within one of the exceptions to the OID rules. The existence of unstated interest is tested with reference to the applicable Federal rates established under the OID rules. Where imputed interest is present, however, it will be taken into account only as payments are made (rather than under an accrual method, as provided in section 1274). Thus, under section 483, "principal" payments are recharacterized as interest to the extent that imputed interest has accrued but has not been paid through the time of payment.

In cases involving the sale or exchange of a principal residence (to the extent of the first $250,000 of the cost of the residence) or farmland costing less than $1 million, the 1984 Act provided that the test rate previously applicable under section 483 would apply. Thus, the existence of unstated interest would be determined by reference to a 9 percent test rate.

4. Public Law 98-612

After passage of the 1984 Act, a number of concerns were raised regarding the impact of the changes described above on relatively small transactions. To address some of these concerns temporarily and permit the Congress to reexamine the OID and imputed interest rules in this session, Congress passed P.L. 98-612 in October 1984 which contained temporary and permanent rules relating to seller-financed sales of property. Most importantly, P.L. 98-612 provided that for sales or exchanges of property (other than new section 38 property) occurring prior to July 1, 1985, the test rate is 9 percent (compounded semiannually) on up to the first $2 million of seller financing. For transactions involving more than $2 million of total financing, the test rate is a weighted average of 9 percent and 110 percent of the applicable Federal rate.

P.L. 98-612 also provided that sections 1274 and 483 generally apply to assumptions of existing obligations in connection with sales or exchanges of property or taking property subject to an existing obligation. Congress, however, specifically exempted from the scope of sections 483 and 1274 assumptions of obligations originally issued on or before October 15, 1984, in transactions where the sales price does not exceed $100 million. P.L. 98-612 also provided exemptions from the rule on assumptions generally for transactions involving (i) personal residences, (ii) property used in the active conduct of the trade or business of farming, and (iii) property (other than new section 38 property) used in an active trade or business.

5. Pending Bills

Several Senate bills have been introduced this year to amend the imputed interest and OID rules. S. 56 and S. 71 are identical and would provide lower test and imputation rates for transactions involving residences, farms and small businesses and for sales or exchanges of real property generally, if certain conditions relating to the term of the debt instrument and the time for payment of stated interest are met. These bills would also place limits on increases in the test rate and allow a cash accounting election for transactions under $4 million. S. 729 would provide a test rate equal to the lower of 9 percent or 80 percent of the applicable Federal rate for transactions involving $4 million or less of seller financing and a test rate of 80 percent of the applicable Federal rate on larger transactions. S. 729 would also allow cash accounting for transactions involving $4 million or less of seller financing and would also exempt assumptions of existing obligations from the imputed interest and OID rules. S. 217 and S. 251 are similar to S. 729, but establish a $2 million threshold for the special alternate test rate of 9 percent.

II

SMALL TRANSACTIONS

Although the principles underlying the OID and imputed interest rules are equally applicable to all seller-financing transactions, we recognize that these rules impose additional burdens in planning sales transactions and that these burdens weigh proportionately more heavily on small transactions. Therefore, we agree it is appropriate to consider rules that would simplify the system for small transactions.

We feel obliged to point out to the Subcommittee, however, that any system that provides different rules for small and large transactions must also describe in what circumstances transactions will be aggregated for purposes of ascertaining whether the small transaction rules should apply. Without clearly defined aggregation rules, the large transaction rules could easily be avoided. For example, a seller of a single piece of property worth $5 million cannot be permitted to benefit from the small transaction rules by selling five separate 20% interests in the property to the same buyer in five transactions taking place at substantially the same time. While this type of abuse can be dealt with easily enough, other cases involving a single seller and multiple buyers or multiple sellers and a single buyer will present significant problems. While the difficulties of formulating fair and workable aggregation rules are not insubstantial, we believe that these problems are outweighed by the need to provide simpler rules for small transactions.

1. Fixed Test Rate

Prior to the 1984 Act, the prevailing test rate was widely known and individuals could structure routine transactions without consulting tax periodicals or a tax professional to determine the current applicable Federal rates. To continue this system for relatively small transactions, we would support the application of a fixed lower test rate. This rate would be adjusted only to reflect significant long-term shifts in market interest rates.

We suggest that the lower rate be fixed initially at 9 percent, based on compounding at least annually. This fixed rate would provide a degree of certainty and simplicity for small transactions by removing the need to refer to the applicable Federal rate, which changes frequently. To give some effect to shifts in market rates, however, this fixed rate might be adjusted when the applicable Federal rates shift very substantially and remain at the new levels for a relatively long time period. Of course, if the test rate applicable to large transactions actually fell below the fixed small transaction rate, the parties would be permitted to use the lower test rate.

A fixed rate for small transactions, adjusted infrequently is far preferable to a floating rate based on a fixed percentage of the applicable Federal rate as is provided in each of the pending bills. Although such a system would always result in a below-market test rate for small transactions, the floating rate would do nothing to eliminate the uncertainty for transactions involving relatively small amounts of money since the parties would still be required to consult current market interest rates simply to structure such transactions.

2. Definition of Small Transaction

The distinction between large and small transactions can be based on either the purchase price of the property or on the amount of seller financing involved. If the purchase price of the property is the basis for the distinction, we suggest that the special rule for small transactions be limited to transactions with a purchase price of $2 million or less. For this purpose, purchase price would include cash and the fair market value of any property transferred to the seller, as well as the stated principal amount of any financing. Alternatively, if the Subcommittee prefers to continue to base the distinction between large and small transactions on the amount of seller financing, we suggest that the special rule for small transactions be limited to transactions where the amount of seller financing does not exceed $1 million.

Several of the bills pending before this Subcommittee establish a threshold of $4 million of seller financing for lower test and imputation rates and for special accounting rules. In transactions of this magnitude, the parties generally are sufficiently sophisticated to be aware of current market interest rates, and we are not persuaded that the additional complexity involved in consulting current applicable Federal rates is burdensome when compared to the other complexities that inevitably accompany a sale of such an expensive property. When a below-market interest rate is charged in such large transactions, the parties should be fully aware of the relationship between the purchase price and the interest rate charged, as well as the resulting tax consequences. Therefore, we strongly urge that the "small" transaction threshold be set below $4 million.

3. Application of OID Rules to Small Transactions

Several of the bills provide that parties to a transaction involving an amount of seller financing below $4 million have the option to elect cash accounting for both parties in lieu of the

OID rules. In evaluating this option, it is important to bear in mind that the OID rules apply only if the parties to a sales transaction do not provide adequate stated interest or if the transaction does not call for interest to be paid currently. Since virtually all taxpayers will provide at least 9 percent interest required to avoid imputed interest, this option is important only in situations where the parties provide for deferred interest.

We acknowledge that an election to report deferred payments on the cash method may be simpler for the parties than the OID rules. However, the existence of two separate accounting systems for small and large transactions also would create new complexities. For example, assume that property is sold under the small transaction rule and the parties elect the cash method; subsequently, the property is resold in a transaction which is subject to the OID rules and the original obligation is assumed. In this situation, may the subsequent purchaser accrue interest deductions currently while the original seller continues to report interest income only as received? Alternatively, assume the seller of the property disposes of the buyer's obligation to an accrual basis taxpayer. Is the subsequent holder entitled to use the seller's cash matching election? Rules that would have to be provided to deal with such problems would make the cash method election potentially very complicated.

A cash-matching election also involves potential for abuse. For example, an owner of property could sell to a tax-exempt intermediary for a note calling for deferred interest payments, with the parties electing the cash method. The tax-exempt intermediary could then sell to the intended buyer on the same terms, with the buyer and the intermediary not electing the cash method. The buyer could then report current interest deductions under the OID rules, while the seller would have no current interest income inclusion. The intermediary would use its tax exemption to insulate itself from adverse consequences of the OID interest inclusions.

Although a rule could be designed to address this particular arrangement, we are not optimistic that every type of transaction which is similar to this arrangement and exploits differences in marginal tax rates could be stopped. If effective anti-abuse rules are not developed to address all schemes structured to avoid the requirement that the parties to a deferred payment sale of property account consistently for the interest element in the transaction, one of the major abuses addressed in the 1984 Act, the potential for mismatching income and deductions, will remain.

In view of the inevitable complexity involved with separate accounting systems for small and large transactions and the potential for abuse, we would urge the Subcommittee not to adopt a special accounting rule for small transactions.

4. Application of Small Transaction Rules to Dealers

We suggest that any special rules for small transactions apply only to casual sales of property. Special rules for small transactions can be justified only on the ground that the generally applicable imputed interest and OID rules are too complex when relatively unsophisticated parties are buying or selling property. Dealers that regularly transact for the sale or purchase of property are sufficiently sophisticated to be aware of current market interest rates. Indeed, many dealers in residential real property are New York Stock Exchange-listed firms that engage in thousands of sales annually. These taxpayers have little basis for claiming the new imputed interest and OID rules are overly complex. Moreover, exempting dealers from the small transaction rule would obviate many of the more difficult aggregation issues referred to earlier.

5. No Special Rule for Sales of Certain Types of Property

A broadly-based special rule for small transactions would provide a degree of certainty for parties to routine sale transactions and can be justified on the grounds of simplicity. This rule would apply sales of all types of property including, sales of small businesses, residences and farms. Therefore, we oppose providing additional exceptions to these rules for transactions in these or other special types of property, such as is provided in S. 56 and S. 71. Exemptions for transactions involving certain types of property are unnecessary in light of the small transaction rule and constitute a subsidy for transactions in such types of property. Moreover, each additional exception adds complexity to the Internal Revenue Code and to the regulations as rules must be formulated defining the scope of each exception, identifying and preventing abuses, and regarding the interrelationship of the various exceptions.

If a general exception for small transactions of all types is adopted, the existing special rules that provide lower rates for transactions in certain types of property are no longer needed. Thus, we would support the repeal of the existing special rules for certain types of transactions, including the rules relating to sales of principal residences, sales of farms and sales of land between related parties.

III

SUGGESTED CHANGES TO THE BASIC RULE

Although we believe that the rules enacted in the 1984 Act generally provide for the correct treatment of seller-financed sales of property, we think that a number of improvements can be made in the existing statutory structure. I turn now to these matters.

1. Selecting the Appropriate Interest Rate Index

As I have already stated, if one party sells a piece of property to another in a transaction that calls for one or more deferred payments, and if the deferred payments do not include an interest charge at a market rate of interest, the parties have the opportunity to overstate the purchase price for the property. The question then arises: What constitutes a "market rate of interest"? The current statute answers this question by reference to the rate at which the Federal Government borrows money, taking into account (to a limited extent) the term of the obligation.

We continue to believe that an interest rate index based on the yields on United States obligations is the most reliable and appropriate indicator of market rates of interest, for the following reasons:

- The Federal borrowing rate accurately reflects trends in the market rate at which a given borrower could obtain funds from an unrelated lender.
- A rate based on the yield of U.S. Government obligations is not subject to manipulation.
- U.S. Government rates are readily available; no data need be gathered from third party sources.
- There is a large volume of U.S. obligations with remaining maturities ranging from 30 days to 30 years. This assures a statistically valid data base from which to compute the market interest rate index.

The imputed interest rules provide that the applicable Federal rate is multiplied by a factor of 110 percent to compute the appropriate test rate. This multiple reflects that even the most creditworthy borrower will not be able to borrow at a rate as low as the Federal Government pays on its obligations. We support retention of the 110 percent factor applied to the applicable Federal rates to determine the testing rate for whether a transaction has adequate stated interest. The factor is not punitive; in many arm's-length lending transactions the market rate of interest would be 130 percent, 140 percent or more of the applicable Federal rate, due to the creditworthiness of the borrower.

Attached to this testimony are four charts which show the relationship between private and Federal Government interest rates over the course of the last eight years. Chart 1 compares the FHA mortgage rate to a Federal long-term composite rate.1/ This chart shows a close relationship between the two indices during all periods, with the FHA rate consistently above the Government rate.

Chart 2 compares the FHA index to 110% of the long-term Government index and shows that at no time during this period did the FHA rate ever drop below 110 percent of the long-term rate. This relationship indicates that a test rate based on 110 percent of a Federal long-term borrowing rate is entirely appropriate.

Charts 3 and 4 provide the analogous comparisons between the average prime lending rate and the average yield on new issues of 1-year Government securities. Again the correlation between the two averages is extremely high. Chart 4 shows that the prime rate was always at least 110 percent of the 1-year Government rate.2/

1/ The FHA mortgage rate is the rate charged to home buyers for FHA-insured mortgages. The Federal long-term composite rate index is based on yields of Government bonds with constant maturities of 10 years or more. The latter index is very similar to the Federal long-term rate of current law and was chosen in lieu of the Federal long-term rate because past data for the latter index are not readily available. Both indices are compiled from data published in Domestic Financial Statistics, a publication of the Federal Reserve Board.

2/ The data on the prime rate and the 1-year Government rate on new issues are also taken from Domestic Financial Statistics. Private borrowing rates are quite likely to exceed the prime rate, especially on lending transactions of more than one year (but not more than 3 years). Also, the 1-year Government rate on new issues will not be identical to the Federal short-term rate since the latter index takes into account all maturities of 3 years or less on all outstanding issues.

A number of the bills before this Subcommittee today would lower the test rate to 80% of the applicable Federal rate for certain types of transactions. We urge this Subcommittee not to adopt such change. Allowing taxpayers to state interest rates as low as 80% of the AFR would allow very substantial overstatements of true purchase price in sales of property calling for deferred payments. This overstated purchase price benefits both the seller (in the form of a conversion of ordinary interest income into capital gain) and the buyer (by converting interest deductions into depreciable basis that can be written off on an accelerated basis).

At current interest rates, a shift to a test rate of 80 percent of the applicable Federal rate would allow a basis overstatement in any sales transaction of more than 30 percent, assuming a purchase money loan for the entire sales price with a term of 30 years and level monthly payments over the term of the loan. For example, a building having a value of $10 million could be sold for over $13 million. In the case of loans calling for a single payment of principal and interest at maturity, the potential overstatement is far greater. For example, if the debt instrument described above called for a single payment at maturity, the same $10 million building could be sold for a purchase price of over $27 million.

For the tax law to permit distortions of this magnitude would be a substantial step in the wrong direction. A system using a test rate of 80 percent of the applicable Federal rate would present the worst of two worlds; the complexities of a floating test rate would be retained while one of the two major abuses that led to enactment of the 1984 Act provisions (basis overstatement) would remain unchecked.

2. No Blended Rate for Larger Transactions

We do not believe that the test rate for small transactions should apply to any portion of the borrowed amount on a transaction above the small-transaction threshold. Our primary reason for opposing a "blended rate" approach is that there is no reason to provide a test rate which is below a market interest rate for transactions in excess of the threshold amount. The sole justification for the 9 percent rate for small transactions is that it is a fixed, well-known rate that parties can use without reference to floating rates published periodically. This justification disappears as soon as the fixed rate is to be blended with a higher floating rate.

The blended rate also adds a significant amount of complexity to the imputed interest rules. For example, if a small transaction threshold based on purchase price is chosen, parties negotiating a sale of property for a purchase price in excess of the threshold amount will not know the minimum interest rate that needs to be charged because that rate will depend on the purchase price. Since the purchase price will depend in turn on the interest rate to be charged, the parties will be faced with a difficult interrelated computation that can be solved only through the use of sophisticated mathematical techniques. (Similar problems would arise with a threshold based on seller financing.)

Finally, a blended rate for transactions in excess of the threshold amount is not necessary to avoid a "cliff", that is, a dramatic difference between the tax consequences of a sale of property with a value just below the threshold amount and the consequences of a sale of property worth just over the threshold amount. In fact, a specific dollar limit based on either the stated sales price or the amount of seller financing essentially operates as a gradual phase out of the lower rate.

To see why this is so, one must bear in mind that the right to state a 9 percent interest rate when prevailing market rates are higher allows parties to overstate the purchase price of the property sold. For example, if the prevailing market interest rate is 12 percent and the property is to be paid for in ten equal annual installments, the purchase price of the property is overstated by a factor of approximately 13.6 percent. Thus, a sale of property for a $1 million note with interest a 9 percent on these terms would indicate a true value of the property of approximately $880,000. For property having a value of more than $880,000 but less than $1 million, if the small transaction threshold were $1 million of seller financing, the parties would in each case state a purchase price of $1 million but would charge an interest rate between 9 percent and a market rate to achieve the correct economic result. Thus, the small transaction rule is advantageous until the rate that must be charged equals the rate applicable to large transactions.

The following table illustrates the correlation between the value of property and the interest rate that would be charged if the stated principal amount is $1 million.

Actual Value	Stated Sales Price	Interest Rate
$ 880,418.26	$1,000,000	9.0%
899,889.28	1,000,000	9.5%
919,547.78	1,000,000	10.0%
939,390.94	1,000,000	10.5%
959,415.94	1,000,000	11.0%
979,619.91	1,000,000	11.5%
1,000,000.00	1,000,000	12.0%

We recognize that, notwithstanding the above analysis, a perception remains that a cliff exists between the small transaction and large transaction rules. If this Subcommittee wishes to address this perceived problem, we would recommend a simple phase-out of the benefit of the 9 percent rate for transactions with a sale price between $2 million and $3 million (or seller financing between $1 million and $2 million) rather than a blended rate for all large transactions. This would simplify the system for larger transactions and would have the added benefit of limiting the revenue loss from the 9 percent subsidy rate. The phase-out approach recently adopted by the House Ways and Means Committee could serve as a general model for such a phase-out rule.

3. Conforming the Imputed Interest Rate to the Test Rate

Under current law, if the parties to a sales transaction do not provide for interest at a rate at least equal to the safe harbor test rate, interest will be imputed at a higher imputed rate. For sales involving total financing of $2 million, the test rate is 9 percent and the imputed rate is 10 percent. To the extent the total financing exceeds $2 million, the test rate is 110% of the AFR and the imputed rate is 120% of the AFR.

This feature of current law is a carryover from old section 483, under which interest of at least 9 percent had to be stated to avoid interest being imputed at 10 percent. The original reasons for having different test rates and imputed rates, as well as the reasons for carrying this aspect of old section 483 forward in the 1984 Act, are not entirely clear.

Whatever these reasons, Treasury believes that the system could be made simpler and fairer by setting both the test rate and the imputed interest rate at 110% of the AFR for large transactions and by setting both these rates at 9 percent for small transactions. The system would be simpler because fewer rates would have to be computed, published and assimilated by taxpayers and their advisers. The system would be fairer because parties would not be penalized for failing to provide the minimum interest rate required; the tax law would simply recharacterize the transaction as if this minimum interest rate had been provided.

4. Frequency of Determination -- Semiannual or Monthly?

The 1984 Act calls for semiannual redeterminations of the applicable Federal rates. Soon after enactment of the 1984 Act, however, it became apparent that if taxpayers are to be required to state a market rate of interest, the system cannot work if the test rate is substantially out of date.

The 1984 statute calls for rates that are, on the average, 9 months out of date. Moreover, transactions taking place at the end of a semiannual period would be governed by a test rate based on interest rates in effect as much as 15 months earlier. For example, a transaction taking place on June 30, 1985 would be governed by a test rate determined in part by reference to yields on U.S. obligations during the month of April 1984.

As an interim measure, Treasury decided to address this "time lag" problem by providing in temporary regulations an alternate calculation of the applicable Federal rates, based on monthly rather than semiannual recomputations. This substantially reduces (but does not eliminate entirely) the time lag problem. The monthly rates were provided as an alternative to the statutory semiannual rates; the latter rates remain available in the event they are lower.

In moving from a semiannual to a monthly redetermination of the applicable Federal rates, we recognized that to some extent we were making it more difficult to negotiate and plan sales transactions. To ease this problem, we provided an additional special rule, allowing taxpayers in a given month to use the rates in effect for the preceding and the second preceding month (in addition to the current month's rates). This rule assures that, once a set of monthly rates is published, taxpayers can be assured that the applicable Federal rates will be no higher than those rates during a three-month period.

We believe that the system of Federal rates computed on a monthly basis contained in the recently released temporary regulations strikes a reasonable balance between the need to reduce the time lag problem and the need to provide some planning stability to taxpayers. We urge this Subcommittee to adopt the system of monthly rates contained in the recent temporary regulation in lieu of the statutory semiannual system. We see no need to continue a dual system, especially since the statutory rates can result in substantial overstatements of basis in times of rising interest rates. More significantly, codifying the monthly approach of the regulations as the exclusive means for determining the applicable Federal rates would be far simpler than the current dual system.

5. Limiting the Variation in the Applicable Federal Rate

A number of the bills before the Subcommittee today would limit the amount by which the applicable Federal rates could increase from one period to the next. For example, S. 56 and S. 71 provide a special rule limiting the increase in the applicable Federal rates if such increase otherwise would be more than 2 percentage points. These types of proposals are sometimes referred to as placing a "governor" on the applicable Federal rates.

As the charts attached to this testimony indicate, when Federal borrowing rates increase or decrease significantly, market interest rates in private lending transactions faithfully reflect the increase or decrease. This applies to short-lived peaks and valleys as well as long-term trends. To deny this reality by placing a governor on the applicable Federal rates would simply give taxpayers an opportunity to understate true borrowing costs and overstate basis until the applicable Federal rates had time to catch up with the change in the market rates. Therefore, we believe that placing a governor on the applicable Federal rates is both unnecessary and unwise.

It has also been suggested that an overall cap be placed on the applicable Federal rates. S. 56 and S. 71 would place an increasing cap on these rates through the end of 1986. As with the governor, we believe that a cap is inappropriate. While interest rates are not expected to increase in the short run, so that a cap would not be expected to have any immediate effect, placing a cap on the applicable Federal rates would result in significant distortions and resulting loss of revenue if at some future time interest rates do rise above the cap.

6. Alternate Methods of Proving Adequate Stated Interest

As noted above, the function of the applicable Federal rates is to serve as an objective indicator of current market rates of interest for short-term, mid-term and long-term lending transactions. However, even with a shift from a semiannual to a monthly redetermination of the applicable Federal rates, some time lag remains in the system. In times of rapidly falling interest rates, the market interest rate actually in effect at the end of a given month may be significantly below the applicable Federal rate for that month. This time lag is inevitable in any system under which test rates are computed and published on a periodic basis.

A related problem arises from the classification of all lending transactions into short-term, mid-term and long-term for purposes of determining the applicable Federal rate. If an actual transaction has a relatively short maturity among transactions within its class (for example, a 1-year loan, a 4-year loan or a 10-year loan), the use of an average yield for all maturities falling within that class may unfairly prejudice the relatively short maturities.

To take care of these and similar problems, we do not believe it is appropriate to attempt to make specific statutory refinements in the applicable Federal rates (such as weekly adjustments in the rate or narrower classifications of obligations by maturity). Such refinements would unduly complicate the system with only a minimal gain in accuracy. Instead, we think that taxpayers should be given certain opportunities to demonstrate that their transaction contains adequate stated interest other than by reference to the applicable Federal rate.

First, we believe that taxpayers should be permitted to compute and use indices based on the same principles as the applicable Federal rate but with greater accuracy than the published rates. For example, if a taxpayer selling property with the payment of principal due in 10 years could show that 110 percent of the average yield on 10-year Treasury securities was less than the interest rate provided in the sales transaction, the transaction would be treated as having adequate stated interest. Information of this type is readily available in weekly and monthly publications of the Federal Reserve Board.

Second, if a taxpayer can demonstrate that third-party financing could have been obtained by the buyer on the same terms as provided in the seller financing, the debt will be considered to have adequate stated interest. The taxpayer would have to show that this financing was available to a broad segment of the general public and that the buyer's creditworthiness would have allowed it to qualify for this financing; a mere letter or affidavit from a bank stating that it would have been willing to provide the funds on the stated terms would not be sufficient if no such loans were actually made on those terms.

Finally, sellers of fungible units of personal property on the installment basis should be given the opportunity to demonstrate that the financing contained adequate stated interest by showing that substantial numbers of the same item of property were sold for cash at the same price to other purchasers.

We believe that the regulatory authority in the current statute is broad enough to allow us to address these situations. However, we would welcome legislative confirmation of this authority on these particular points.

IV

ASSUMPTIONS OF EXISTING INDEBTEDNESS

1. Background

The last major issue that I would like to address today concerns the treatment of assumptions of existing indebtedness on property. The problem, simply stated, is that when property is sold and, as part of the consideration for the sale, the buyer assumes liability for an indebtedness with an interest rate that is below a market rate at the time of the sale, the same potential for overstatement of purchase price is present as in the case where the indebtedness is seller financing.

The problem may be illustrated by the following example. Suppose A, a commercial lender, lends $100 to B at 12%, which is a market interest rate at the time of the loan. B uses the $100 to purchase depreciable property and secures the note with the property. Some time later, when market interest rates have risen to 15%, B sells the property to C. The fair market value of the property, if unencumbered, remains at $100. However, because C is able to assume B's favorable indebtedness to A, C is willing to pay a total purchase price of $120, that is, C assumes B's $100 debt to A and pays B $20 in cash.

The extra $20 that C is willing to pay B has nothing to do with the value of the property sold; it simply reflects the fact that B's obligation to A is less of a liability because of the increase in interest rates. If the imputed interest rules do not apply to this transaction, C will be able to write off the extra $20 as depreciable basis. If the term of the debt is longer than the ACRS life of the property, this gives a significant advantage to C.

The seller B also benefits from the overstated basis in the following way. B originally owed $100 to A. When the property securing the debt was sold, B gave up property worth $100 in exchange for $20 in cash and C's assumption of B's debt. Thus, B's $100 debt to A was discharged in effect at a net cost to B of only $80. This $20 difference could be properly viewed as ordinary income from cancellation of indebtedness. Instead, unless the imputed interest rules apply to assumptions, C has additional capital gain of $20.

2. Possible Approaches

Several possible approaches have been suggested for dealing with these problems. These may be referred to as the novation approach, the wraparound approach, and the anti-abuse approach.

a. Novation - The novation approach treats an assumption as if the existing debt were repaid upon sale and a new debt issued by the original lender to the buyer. Thus, in the above example, the buyer C would have a depreciable basis of $100 and additional interest deductions of $20 over the life of the loan and the seller B would have ordinary income from the cancellation of indebtedness of $20. To complete the picture, the original lender A should be given a bad debt deduction of $20 to match B's income inclusion and would have interest income of $20 over the remaining life of the loan to match C's interest deductions.

b. Wraparound - The wraparound approach treats an assumption as if the seller remained liable on the original debt and issued new seller financing to the buyer. This approach has appeal primarily where the seller in fact remains secondarily liable on the assumed debt. In terms of the example, the treatment of the buyer C would be the same but the seller B would have interest income of $20 spread over the remaining life of the loan instead of at the time of the sale. The original lender A would be unaffected.

c. Anti-abuse - The anti-abuse approach focuses exclusively on the buyer C and attempts to foreclose the conversion of interest deductions into depreciation deductions in situations where this conversion would present a significant tax advantage. Under this approach, an assumed debt would be subject to the imputed interest rules only if the property securing the debt were depreciable in the hands of the buyer and only if the remaining term of the debt were sufficiently long, when compared to the ACRS life of the property, to indicate that the revenue loss from the basis overstatement would be significant. The seller and the original lender would be treated as under present law.

3. Recommendation

Each of the three possible approaches outlined above presents certain advantages and disadvantages. The novation approach and the wraparound approach both entail the matching of income and deductions and hence would be quite effective in preventing abuse. However, the novation approach is difficult to justify if the consent of the original lender is not required for the assumption. The wraparound approach would seem to be correct only where the seller remains secondarily liable on the assumed debt and presents significant issues relating to the timing of the seller's gain under the installment sale rules. Finally, adoption of either the novation or the wraparound approach arguably would require a broad-based reexamination of fundamental principles relating to cancellation of indebtedness income, market discount, and other aspects of the taxation of financial contracts, an inquiry that would not seem advisable at the present time.

In addition, we would be quite concerned if anything in legislation pertaining to the imputed interest rules were to bolster the position taken by some taxpayers that the gain upon the disposition of property encumbered by debt in excess of the seller's basis can be avoided through the use of wraparound indebtedness. In this regard, we oppose those aspects of S. 721 that would provide special treatment under the imputed interest rules for wraparound indebtedness.

We would suggest that the Subcommittee give its primary attention to the formulation of an anti-abuse rule along the lines described above. We would be happy to work with the Subcommittee in the design of such a rule. Of course, the rule would apply only to assumptions of indebtedness placed on property after October 15, 1984 or in excess of $100 million. We see no reason to move this date forward since the anti-abuse rule would apply to a more limited class of taxpayers than those covered by P.L. 98-612.

* * *

This concludes my prepared remarks. I would be happy to answer your questions.

Chart 1

Private and Government Interest Rates

Long-Term

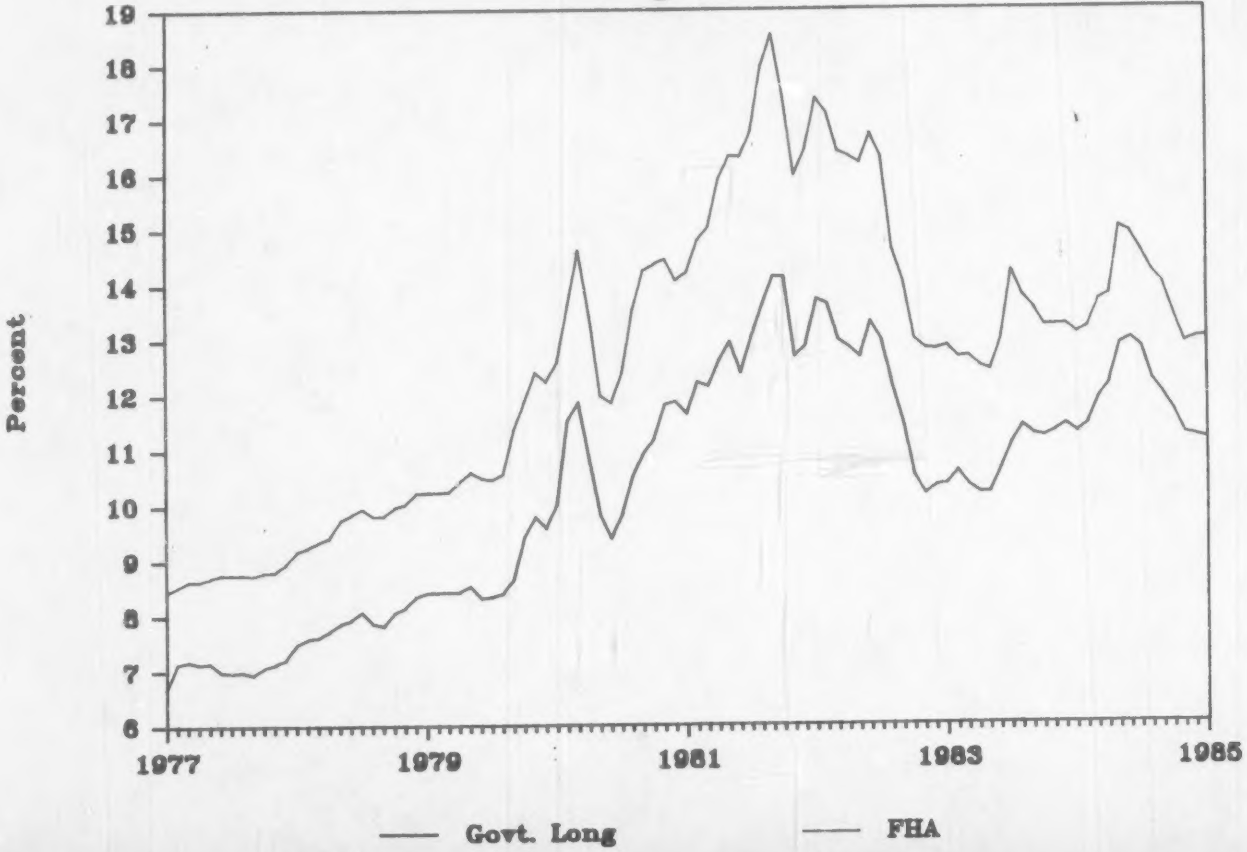


Chart 2

Private and Government Interest Rates

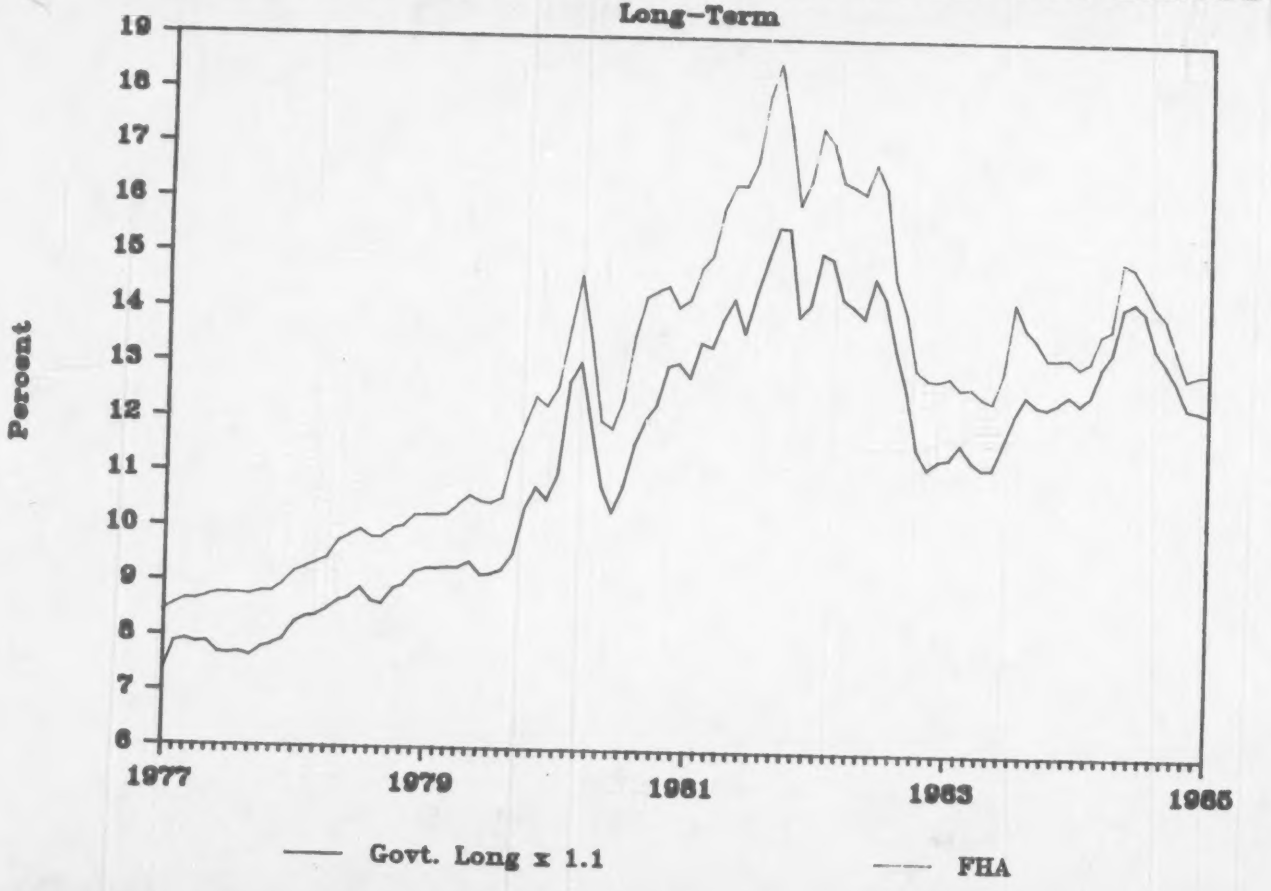
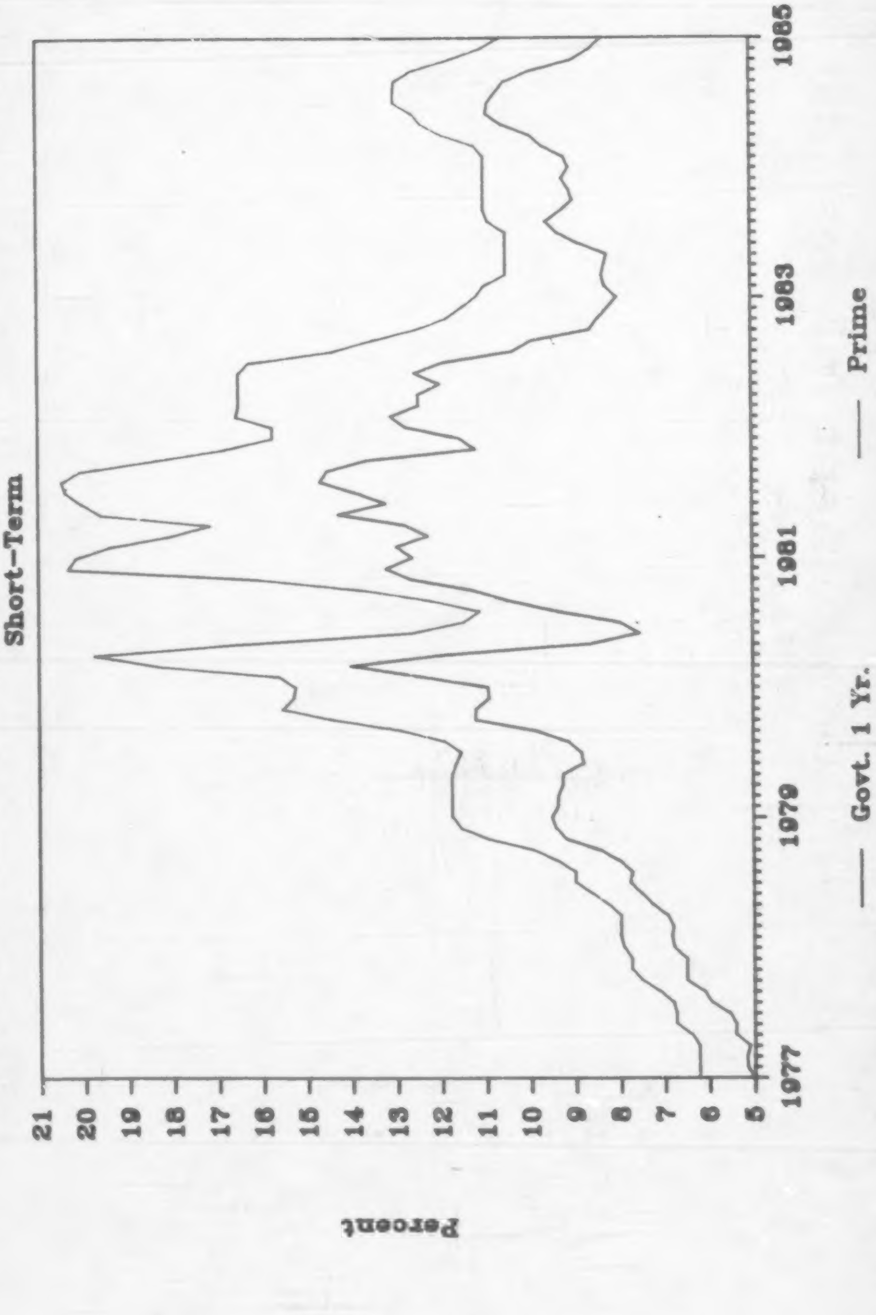


Chart 3

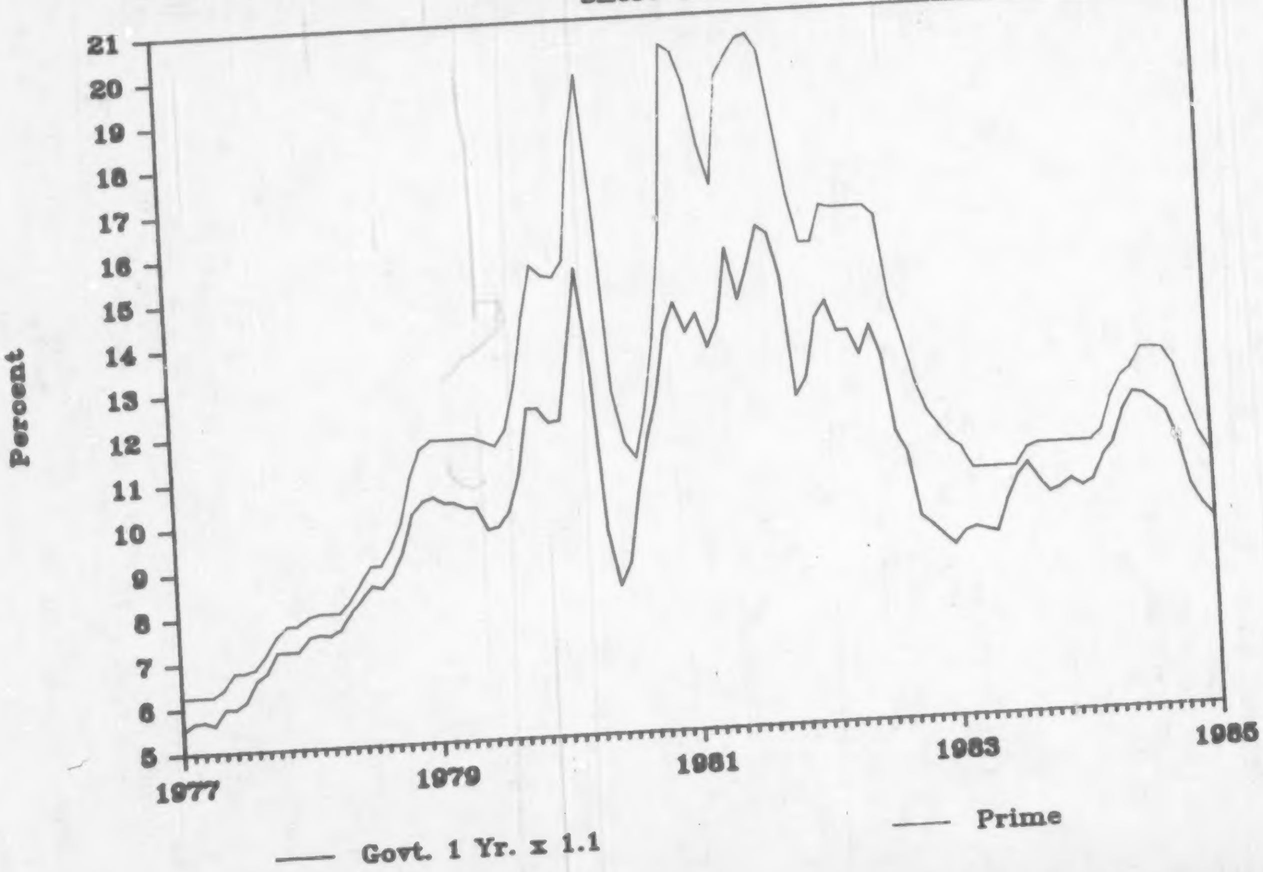


Private and Government Interest Rates

Chart 4

Private and Government Interest Rates

Short–Term



Senator CHAFEE. First, I want to welcome Senator Symms. Do you have a statement of any kind you wish to make?

Senator SYMMS. No, Mr. Chairman; I have a couple of questions. I will try to make it all in one shot here. It may not even take 5 minutes. I guess I have to say, Mr. Pearlman, that I am very much sympathetic to what Senator Wallop was saying. I, for the life of me, with Treasury making preparations to come out with a tax reform proposal, can't understand why Treasury wouldn't just want to go back to the pre-1984 law and operate under that until the entire picture of tax reform is resolved. I guess Senator Chafee indicated maybe he wouldn't agree with that, but I find it very difficult, from a philosophical standpoint, to believe that when there are two consenting adults out there making an economic transaction, it is any business of the Federal Government's in the first place. The important thing is that they end up paying their taxes, whether it be capital gains or otherwise, on the interest. I can't see why a Federal policy wouldn't encourage lower interest rates. Isn't there a point where we should be encouraging people to reduce rates to 8 percent or 7 percent so the banks are still under pressure to try to meet those obligations? What do you say to that?

Secretary PEARLMAN. Senator, the market should be the governor. I completely agree. The problem we have that Senator Wallop and I were discussing—I think before you came in—is that in seller-financed transactions we have parties wearing two hats. If I am selling property and I go to an independent third party, whether it is an individual or whether it is a bank, and borrow money, then that sets a real rate of interest, and we don't have to worry about it from a tax standpoint generally, and there are exceptions even to that. The problem is when we put the seller in the same transaction as the lender, and when we do that, we can say to the parties: You set whatever terms you want to set between you—we don't care. If you want to call something interest, call it interest, if it makes you feel better. But for tax purposes, we have got to have the ability to come in and say, hey, wait a minute—just because you said no interest was charged in a transaction, we can't let a tax system function that way because there is a concept of interest income and interest expense in the system. So, the tax system—and it is not new to the imputed interest rules, and it is not new to 1964—we have always in the tax system had to say we can't let taxpayers tell us what the tax consequences of the transaction are. We have got to say you can set the deal as you want to set, but there have got to be tax rules that say, hey, wait a minute, that is not capital gain. You might say it is capital gain, but I——

Senator SYMMS. I understand there is a differential between capital gain and ordinary income, and that is what you are talking about. However, the 1964 law that we have operated under up until now certainly does not allow you to lower the interest rate to 1 or 2 percent if the prime rate is 10. It allows you to go to 9 percent. Isn't that the lowest?

Secretary PEARLMAN. Nine, and in some instances 6. That is right. If you have got a 10-percent commercial rate, the problem is not as serious. When you are in real estate transactions——

Senator SYMMS. Let me ask you a question. Let's just say, for example, that a person does have $1 million in cash, and he enters into an agreement where he lends that $1 million in cash to another party and is willing to accept 8 percent interest for it. Is there any complaint about that with respect to the Treasury?

Secretary **Pearlman**. Sure, if it is not a market rate of interest. We don't want people to convert, even in a straight lending transaction indeed there are rules that have——

Senator **Symms**. No; just a straight lending transaction.

Secretary **Pearlman**. In a straight lending transaction——

Senator **Symms**. In a straight lending transaction, one guy has $10 million and somebody comes in and says I want to borrow $1 million from him, and he says I will lend it to you. I want 8 percent. So, he turns in on his income taxes and says I got $80,000 last year from this $1 million that I lent to the ABC Distributing Co., or something. Now, what do you say to that?

Secretary **Pearlman**. It depends on what kind of parties you are talking about. If you are talking about just two individuals, unrelated—not employer-employee, not family members—then they can do what they want to do under current law.

Senator **Symms**. All right. Thank you very much.

Senator **Chafee**. Mr. Pearlman, basically, what we did—forgetting the original issue discount—but just looking at the the imputed interest—was to change the imputed rate from 9 percent to a variable rate, in recognition that the interest rates in the country are not always 9 percent. In some instances, interest has been 19 percent. In recognition of that we established an imputed rate based on a percentage of the Treasury rate. Isn't that what we have done?

Secretary **Pearlman**. If you leave the timing issues, the original issue discount rules aside, that is exactly what you have done. Yes, sir.

Senator **Chafee**. To me, that makes perfect sense. We have recognized in a whole series of situations that borrowing has changed. I think some folks use to be able to borrow on insurance policies at 5 percent. Well, that is insanity because the company can't itself go out and get that money to lend it to us at 5 percent. So, the insurance policy has been changed. I don't know whether the Government insurance policies have been changed, but they sure should have been. Now, let me ask you a couple of questions. Is there a need for the imputed interest rate to be applicable to sales where the property isn't appreciable?

Secretary **Pearlman**. Yes. And the reason for that is that we have not only depreciation and investment tax issues, but we have conversion issues. That is, the ordinary income-capital gain distinctions, so that it is just as important—perhaps in that transaction certainly more important—to make sure that what is properly interest income is not converted into capital gain or, as I mentioned earlier, in the case of a sale of a residence, into gain which may never be taxed because of the preferential rules we apply to the sales of residences.

Senator **Chafee**. Now, you talked about wraparound debt, and I am not clear what your answer was to this question. Should wraparound debt be treated as an assumption for both the imputed interest rate rules and the installment sales rules?

Secretary **Pearlman**. I think clearly, in my judgment, it should be treated as an assumption for installment sale rules, but let me emphasize that that is an issue that there is a lot of disagreement on. There is a lot of disagreement about the proper characterization of wraparound debt for installment sale purposes. It is the subject of a proposed regulation. The proposed regulation takes the position that you do disregard the debt. The original transaction in my example with Senator Symms was as if he sold the property and fully realized the amount of the debt on the sale. That issue has been debated strongly over the last several years. In the imputed interest and the original issue discount area, in our judgment, clearly wraparound debt should be viewed as debt assumption. The thing we are concerned about is that if the Congress chooses to exempt assumptions from tax and seeks to include wraparound debt in that exemption, that it not use that as a vehicle, and I would think it would be unwitting—I hope it would be unwitting—to produce the wrong result under the installment sale rules. I think a wraparound debt is debt assumption for the original issue discount and imputed interest rules and should be treated the same. And in fact, I think if there is an exemption here, it should apply to wraparound debt, but we would not want to extend that to the installment sale area.

Senator **Chafee**. The House bill is theoretically revenue-neutral because it paid for the changes in the imputed interest rate reductions by extending the cost recovery period for real property from 18 to 19 years. Now I understand from the rumor mill that the tax reform package may also extend the cost recovery period for real property. If we go ahead here in Congress and do what the House did—in other words, lower that imputed interest rate to 100 percent of Treasury or whatever it is and thus have to make up the loss of revenue by going from 18 to 19 years—then we have used up the revenues that the Treasury might be needing in its tax reform proposal. Does it therefore mean that we will be unable to use those revenues in the tax reform program to lower the rates?

Secretary **Pearlman**. Without commenting on rumors, which I won't do, I think——

Senator **Chafee**. Well, you can give us a couple of hints. [Laughter.]

Secretary **Pearlman**. I think the best thing to do is to read the newspapers. I think certainly any expansion of the tax base which would result from extending the recovery period currently on nonlow income housing real estate from 18 to 19 years means that we would be at a different revenue base for fundamental reform purposes than we would today, before that action is taken. Realistically, however, I think that the fundamental reform process is going to involve so many provisions, so many issues in the code that the question of how reform fundamentally is going to be revenue neutral is going to be such an expansive and broad one that I would not suggest to you that you need to be concerned that it is going to endanger the fundamental reform effort simply by making it a decision on the short term on depreciation rates.

Senator **Chafee**. Are you saying that the amount of revenue involved is so modest in connection with the total reform package, that this is acceptable?

Secretary **PEARLMAN**. I am simply saying that it is modest in comparison to a full reform package, certainly. You know we are talking about the entire revenue base when we are talking about a fundamental reform, but I would simply suggest to you that I think there are going to be so many issues involving revenue—the rate obviously being the most significant one—that in designing a reform package, Congress is going to have to do it. We have now done it twice—we are now experts. We are going through it a second time. You really have to start from scratch and say what are your substantive assumptions? What kind of rules do you want? And then try to figure out where you are revenue-wise, and frankly, $1 billion here or there in that process does become rather insignificant.

Senator **CHAFEE**. If we needed alternative measures, other than the extension of the cost recovery period, do you have any suggestions?

Secretary **PEARLMAN**. No.

Senator **CHAFEE**. That is what I thought. What portion of real estate transactions are seller-financed? Do you have any idea? I found that statistic, as I indicated with Senator Melcher, of 80 percent must be unique to Montana.

Secretary **PEARLMAN**. None of us know, but we might be able to get you some information on that. We will try to do that.

Senator **CHAFEE**. I have some statistics from the National Association of Realtors which indicate that in 1982, a year when it was tough to sell a house because interest rates were high and I presume, therefore, seller financing was more used than normally, 34 percent of residential sales and 41 percent of farm sales were seller-financed in whole or in part. These sales weren't 100 percent debt financed. There was probably some equity by the purchaser, but the seller was involved.

Secretary **PEARLMAN**. We will try to provide some information for you if we can.

Senator **CHAFEE**. Do you have any further questions, Senator Symms?

Senator **SYMMS**. Thank you, Mr. Chairman. First of all, I didn't agree with what we did last year and have been resisting it. I still have hopes that Treasury will see the light and go back to the pre-1964 law, although it doesn't sound like it here this morning, but maybe it might still happen. I want to ask this question. Let's say someone built an apartment house or a commercial building to lease for office space and they have a high vacancy rate. I have been told that if they go out and offer somebody a 5-year lease with them and give them 1 year free and then they start the 5-year lease, that Treasury is expecting them to start paying income taxes on the money prior to the time that they actually receive any payments. Is that correct?

Senator **CHAFEE**. I am very reluctant to get into that. It is not an issue of the hearing today. If you have a brief answer, fine, but we have eight witnesses left.

Senator **SYMMS**. All right.

Secretary **PEARLMAN**. Why don't we see if we can do this? Why don't we see if we can get the answer aside from this.

Senator **Chafee**. I don't want to cut you off, Senator. It is just that we have a very complicated subject before us.

Senator **Symms**. All right. Thank you, Mr. Chairman.

Senator **Chafee**. Thank you. Thank you, Mr. Pearlman.

All right. The next panel is Mr. Wallace, the president-elect of the National Association of Realtors; David Smith, first vice president, National Association of Home Builders; Steven Wechsler, vice president and general counsel of the National Realty Committee; and Scott Slesinger, executive vice president of the National Apartment Association. Could you come in that order as you face us, please? Mr. Wallace to the extreme left, Mr. Smith, Mr. Wechsler, and Mr. Slesinger. We are going to take a 2-minute recess here, gentlemen, while you get squared away.

[Whereupon, at 11:10 a.m., a brief recess was held.]

AFTER RECESS

Senator **Chafee**. Now, gentlemen, all your written testimony will go into the record, so don't worry about that. I expect you will basically be saying very similer things, so each of you will have 5 minutes, but obviously, don't feel compelled to take the 5 minutes if you don't need it. If you are just repeating what the other person has said, just emphasize that, but you don't have to repeat every detail. Let's proceed with Mr. Wallace?

STATEMENT OF CLARK E. WALLACE, PRESIDENT-ELECT, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, DC

Mr. **Wallace**. Mr. Chairman, I am Clark Wallace. I am president-elect of the National Association of Realtors, a trade association representing over 670,000 individuals engaged in all facets of the real estate industry in every city, village, and hamlet in America. We appreciate the efforts shown by members of this committee and others in Congress in recognizing that last year's seller-financing provisions were quite simply overkill. Clearly a shotgun was used when a pistol would have been more appropriate. Our concern now is the stopgap legislation which temporarily salvaged the situation expires July 1, 1985, and therefore, now is the time for Congress to put this issue to bed once and for all. Recently, the House Ways and Means Committee began the process of addressing the imputed interest controversy. We believe that the Ways and Means bill is a worthwhile first step in dealing with this problem although other significant steps still need to be taken to ensure that the rules do not paralyze many nontax-motivated seller-financed real estate transactions. We have several basic objections to the 1984 imputed interest rules which will become effective on July 1 if Congress fails to act. Our objections are: First, the interest rates mandated would eliminate the historic ability of seller financing to pick up the slack when high institutional lending rates bring the real estate market to its knees. Second, the 1984 rules are entirely too complex. Third, many unanswered questions have surfaced because of the way the 1984 rules were written, and we fear many more are waiting yet to be discovered. And fourth, the rules literally forced sellers to use the accrual accounting method. Overall, these rules are truly mind boggling for unsophisticated buyers and sellers and must be addressed by this committee and Congress. We are not here today to ask that last year's rules be totally repealed, although we certainly wouldn't object to that. However, we are here today because we believe that failure to act now would mean disaster ahead for seller financing of real estate and thus cripple a substantial portion of the economy at the worst possible time. Let's look for example at what would have occurred in 1982 had the 1984 rules then been in force. In 1982 the average over-the-counter, long-term institutional mortgage interest rate was 13.25 percent, while the average seller-financed interest rate was only 11.8 percent—almost 1.5-percent less. This affordable seller financing interest rate accounted for 34 percent, as you indicated earlier, Mr. Chairman, or approximately 800,000 home sales nationwide and 41 percent of all farm sales in 1982. Seller financing was equally important in that year for commercial office buildings and multifamily structures. Had the new rules been in effect in 1982, sellers would have been required to charge 14.58 percent or have it imputed at 15.9 percent. Buyers which history has shown to be unable to afford the institutional rates during this 1982 period would have also been unable to afford their only other alternative—seller financing—in effect, a much more severe market collapse would have occurred in 1982 had the 1984 rules been in effect. Clearly, this potential future disaster must be corrected, and we are here to tell you that we strongly support the solution to this dilemma contained in Senate bill S. 729 introduced by Senator Durenberger and other members of this committee. And here is why we support that bill. First, the bill would provide interest rates of 9 percent or 80 percent of the AFR, whichever is lower, for seller financed amounts up to $4 million. Second, interest rates on seller-financed amounts above $4 million would have to be at least equal to 80 percent of the AFR. Third, the bill would eliminate the ability of buyers and sellers to mismatch interest income and deductions. And finally, Senator Durenberger's bill would exempt loan assumptions from the rules and only apply the rules to the actual interest return obtained from the seller's equity in wraparound financing transactions. The Durenberger bill addresses Treasury's concern with mismatched interest income by proposing a more livable, real-world solution than simply by forcing everyone onto accrual accounting. The key, we believe, is in establishing a reasonable interest rate in otherwise harsh times. The Durenberger bill does this. While the House Ways and Means bill is a first step toward resolving the issue, it has several shortcomings. For example, it contains a blend approach which applies another complicated formula of dollar-for-dollar reductions to the 9-percent test rate for seller-financing between $2 and $4 million, and it fails to address the important issue of wraparound. So, in essence, our message is this. Allow seller interest rates to be affordable. Make the rules simple. And do it before June 30. Thank you.

Senator **Chafee**. Thank you, Mr. Wallace. Next, Mr. Smith.

[Mr. Wallace's prepared statement follows:]

STATEMENT OF CLARK E. WALLACE, NATIONAL ASSOCIATION OF REALTORS

SUMMARY OF STATEMENT

I am Clark E. Wallace, President Elect of the NATIONAL ASSOCIATION OF REALTORS®. The NATIONAL ASSOCIATION OF REALTORS® represents over 670,000 individuals engaged in all facets of the real estate industry. We commend the Chairman for holding these hearings and for providing an opportunity to discuss permanent imputed interest/seller financing tax rules.

The stopgap legislation enacted late last year which maintained reasonable interest rate rules for many seller financed real estate transactions expires July 1, 1985. Recently the House Committee on Ways and Means began the process of addressing the imputed interest controversy before this expiration date. We believe that the Ways and Means bill is a first step in dealing with this problem although other significant steps need to be taken to ensure that the rules do not paralyze many non-tax-motivated seller financed real estate transactions.

Mr. Chairman, as you know, the imputed interest provisions contained in the Deficit Reduction Act of 1984 have been the subject of intense controversy since their enactment. The reasons are simple:

- The Act proposed to dramatically increase the level of interest required when sellers finance all or any part of the purchase price in a real estate transaction.

- The new required interest rate was linked to a complex indexing formula which set rates well above traditional seller financing interest rates thereby destroying the historical ability of seller financing to counterbalance unaffordable third party lending rates. Specifically, prior to the Act, sellers financing a property sale were required to charge 9% interest. The Act increased this by requiring sellers to charge 110% of the rate paid on government obligations of similar maturity (the so-called "applicable federal rate").

- The proposed increase in required interest rates was so dramatic that many other unanswered questions surfaced concerning, for example, the proper interest rate tax rules applicable to loan assumptions and wraparound financing transactions.

- The Act extended the "original issue discount" rules for the first time to real estate transactions. These rules are designed to eliminate the ability of buyers and sellers to mismatch interest income and deduction by, in effect, requiring accrual accounting by sellers. Thus a "cash basis" seller may be forced to pay immediate tax on unreceived interest income. The amount of forced interest income is determined again by reference to the applicable federal rate. While sounding relatively simple these rules are truly mind-boggling for unsophisticated buyers and sellers.

We appreciate the efforts made by members of this Committee and others in Congress in recognizing the overzealous nature of last year's seller financing provisions and for providing helpful legislation to mitigate the impact which would have resulted to the real estate industry, and to the overall economy, had these rules been allowed to totally take effect as originally scheduled January 1, 1985. However, the stopgap legislation enacted late last year which maintained reasonable interest rate rules for many seller financed real estate transactions expire July 1, 1985 and we urge Congress to promptly address this issue.

If Congress does not act by July 1, then all seller financed sales of multifamily and commercial properties plus sales of principal residences costing more than $250,000 and farms costing more than $1 million will be required to charge interest equal to 110% of the applicable federal borrowing rate. This means that a seller of real property taking back all or any part of the financing for 10 years must charge the buyer 110% of the rate which the Federal government pays on 10 year obligations. Even with the recent decline in interest rates, this requires sellers to charge 13.06% interest. Last summer the long term federal borrowing rate itself was 13% -- meaning an owner would have been required to charge a buyer at least 14.3% interest.

Mandated interest rates at this level would eliminate the historic ability of seller financing to counteract unaffordable institutional lending rates. In fact, in some situations under the Deficit Reduction Act rules, seller financing rates might exceed institutional mortgage rates. Our data, summarized in an appendix to this testimony, shows that about $30 billion of rental residential, commercial and industrial sales would be in jeopardy annually under these rules. This loss of sales would reduce annual Gross National Product by up to $6 billion which represents about 120,000 fewer full time jobs and about $2 billion of lost federal, state and local tax revenues.

RECOMMENDATION

The NATIONAL ASSOCIATION OF REALTORS® strongly supports the legislative solution to the imputed interest issue contained in S. 729 introduced by Senator David Durenberger and other members of this Committee. This solution would ensure the continued availability of seller financing at reasonable interest rates, plus effectively prevent the potentially tax abusive mismatch of interest income and deduction.

S.729 would:*

- allow the prior law interest rate requirement of 9%, or 80% of the "applicable federal rate", whichever is lower, for seller financed amounts of up to $4 million per transaction;

- require interest rates on seller financed amounts in excess of $4 million to be at least equal to 80% of the "applicable federal rate";

- eliminate the ability of buyers and sellers to mismatch interest income and deduction by extending the original issue discount rules to transactions over $4 million and by requiring uniform accounting methods for all smaller seller financed transactions, and;

- exempt loan assumptions from the rules because they have already met the adequate interest requirements when originally issued and, in wraparound financing transactions, apply the rules to the actual interest return obtained from the seller's equity.

* A complete discussion of this legislative solution is presented beginning on page 8.

DISCUSSION OF ISSUE

A. BACKGROUND -- PROBLEMS WITH DEFICIT REDUCTION ACT IMPUTED INTEREST RULES

For many years, the ability and willingness of owners to finance sales of residences, farms, multifamily dwellings and businesses at affordable interest rates has enabled people to continue to do business in spite of unaffordable rates charged by third party institutional lenders. This is especially true during high or rising interest rate periods. For example, during the high interest rate recession of 1982, 34 percent, or approximately 800,000 home sales involved seller financing and 41 percent of all farm sales involved seller financing at an average 11.8 percent interest rate. Seller financing was an equally important financing mechanism for commercial office buildings and multifamily structures.

Prior to the enactment of The Deficit Reduction Act, the law (Internal Revenue Code Section 483) required sellers financing a real estate transaction to charge interest at a rate of nine percent simple, or be taxed as if they were receiving 10 percent compound. These safe harbor and imputed interest rate levels were fixed and subject to change by Treasury Department Regulation.

The Deficit Reduction Act (originally to be effective January 1, 1985, but later partially delayed until July 1, 1985) requires that sellers financing real property sales charge interest at least equal to 110 percent of the interest rate on government obligations of comparable maturity (applicable federal rate). If interest is not charged at this level, then the Internal Revenue Service will impute interest to the transaction and tax the seller as if interest equal to 120 percent of the Federal rate were received. Even though interest rates have "declined" recently, the average interest rate on long term Federal securities today is 11.87 percent; therefore, sellers are being asked to charge at least 13.06 percent interest or be taxed as if receiving 14.24 percent interest.

Federally mandated interest rates at this level are clearly counterproductive to any effort to bring down interest rates and ensure continued economic recovery.

The current difference between long term mortgage interest rates and the underlying inflation rate remains at more than 9 percentage points -- nearly triple the difference existing from 1950-1980. These high real interest rates are already harming the economy and mandating seller-financed rates at this level will unwisely exacerbate this problem.

Supporters of these new, higher safe harbor and imputed interest rate levels make a seriously erroneous assumption to justify The Deficit Reduction Act provisions. These few assume that all sellers who provide financing at rates below those offered by third party institutional lenders do so solely because of taxation concerns. This simply is not the case.

For example, in at least six states, Arkansas, Kentucky, Michigan, Minnesota, Mississippi and Washington, the interest rate mandated under The Deficit Reduction Act would have exceeded the legally allowable state interest rate for individual land sales contracts. Although the imputed interest rate rules are for federal tax purposes and do not technically violate the usury laws, the new rules could require a seller to pay taxes on interest he would not legally be allowed to charge. We believe this is a ridiculous position in which to place taxpayers.

Further, common business practicalities dictate financing terms agreeable to both buyer and seller -- not just taxation concerns. Small commercial and industrial business owners need the flexibility to negotiate favorable financing terms especially during unstable economic periods. The Deficit Reduction Act rules provide no flexibility. Most of the small property owners we are familiar with are fighting for survival and not engaged in tax abuse.

A simple examination of the facts in 1982 relative to real estate finance will demonstrate the potential disaster which these new provisions invite. In 1982, the average long term Federal security rate was 13.25 percent and the average seller financed interest rate was 11.8 percent. Had the new rules been in effect in 1982, sellers would have been required to charge 14.58 percent interest (110 percent of long term Federal security rate) or interest would have been imputed and the seller would have been taxed at 15.9 percent

(120 percent of the Federal rate). Buyers, which the market has shown to be unable to afford third party lending rates during this time period, would now have been unable to afford the alternative seller financed interest rate. In effect, a much more severe market collapse would have occurred.

Not only would the level of interest mandated under The Deficit Reduction Act for seller financed real estate transations defeat the ability of sellers to counteract and help bring down high institutional interest rates but the rules also present the very real possibility that seller provided interest rates would exceed the mortgage interest rates offered by institutional third party lenders. Such a situation would have occurred in June 1984 and is demonstrated below:

TABLE II

Maturity (years)	Yield on Treasury Securities 1/	110 % of T-securities	120% of T-securities	Mortgage Interest Rates 1/
1	12.1	13.3	14.5	13.0
3	13.2	14.5	15.8	14.2
5	13.5	14.9	16.2	14.8
10 or more	13.6	15.0	16.3	14.8

1/ Average for June, 1984
Source: NATIONAL ASSOCIATION OF REALTORS®

Further, under the Act, sellers would be required to know what "applicable federal interest rate" is required. This "rate" did not exist prior to last year's tax bill and even though now applicable for some transactions, we have yet to see the rates published in the Wall Street Journal.

Clearly, if the imputed interest provisions contained in The Deficit Reduction Act of 1984 (IRC Section 1274 and Section 483 as modified by the Technical Corrections resolution) are allowed to become effective as scheduled July 1, 1985, then sellers financing sales of farms costing more than $1 million, small businesses, multifamily and commercial properties and "non principal" residential property could no longer negotiate their own affordable credit terms and would be required to state an interest rate equal to 110 percent of the comparable Federal securities rate. The counterbalance to high institutional lending rates would be destroyed and many, many real estate transactions simply would not be consumated.

B. SOLUTION

The NATIONAL ASSOCIATION OF REALTORS® does not favor the entry of the Federal government into freely negotiated sales contracts. The Federal government setting interest rates goes against the grain of a free enterprise system. It is bad economic policy. Lower interest seller loans are not only the key to the completion of many transactions, they act as a balance against high interest rates and help bring those rates down.

Sellers taking back financing should be able to charge interest rates lower than institutional lenders because, unlike institutional lenders, they do not have to compete for their capital in the lending marketplace and, therefore, generally have a lower cost of money. A seller's money may also have been earned in an earlier, less costly economic environment. In addition, a seller does not have the overhead costs that a lending institution does and likely is willing to accept more risk, i.e., a lower interest rate, because he has a vested interest in selling the property. A seller's rationale for providing financing is completely different from that of a lending institution. An institutional lender earns its profit in lending money. A seller makes profit on property sales. For these reasons, the NATIONAL ASSOCIATION OF REALTORS® recommends that Congress act quickly and enact the following seller financing tax rules embodied in S. 729.

1. Interest Rates/Threshold

The NATIONAL ASSOCIATION OF REALTORS® believes that a reasonable interest rate is the key to the imputed interest solution. Congress recognized in the Deficit Reduction Act, and later in the stopgap legislation, that certain types of transactions (specifically, certain sales of principal residences and farms) should retain the imputed interest treatment of prior law (9%). We believe that this concept should be maintained and extended to all amounts of seller financing below $4 million by requiring a test rate on these amounts equal to the lower of 9% or 80% of the applicable federal rate. For amounts of seller financing exceeding $4 million, we support an established test rate equal to 80% of the applicable federal rate.

These rules would allow sellers taking back relatively small amounts to maintain lower interest rates (9%) than sellers taking back larger amounts (over $4 million), on which interest at least equal to 80% of the federal rate must be charged. When interest rates are high, the 9% amount will maintain preferential treatment for sellers taking back smaller amounts of financing. Thus, unsophisticated transactions would face minimal disruption. When conventional interest rates are below 9%, the 80% option prevents these sellers from having to charge an interest rate greater than that required of sellers taking back large amounts of financing (over $4 million). It is our judgement that interest rates at these levels will preserve the ability of seller financing to counteract high conventional rates plus automatically move in relation to changing market rates -- thus addressing a major concern about prior law articulated by the Treasury Department.

Some have discussed using an index other than the applicable federal rate to determine the required interest rate for "large-scale" transactions (defined in the Durenberger bill and supported by the NATIONAL ASSOCIATION OF REALTORS® as seller financing in excess of $4 million). The cost-of-funds index, which is based on the semi annual report of lending conditions that S&Ls submit to the FHLBB, has been the major subject of this discussion. This index represents the ratio of the actual interest cost of savings and borrowings during a six month period over the average savings plus borrowings based on seven month end figures.

The advantages of the cost-of-funds index include: (1) it is slow moving; (2) borrowers perceive it to be fair; (3) many lenders like it because it is easy to administer; and (4) it is relatively well-known to the real estate industry. The disadvantages to the cost-of-funds index include: (1) the index moves sluggishly which can be a disadvantage when rates are falling; (2) the index has historically never fallen significantly and is not expected to due to the decontrol of passbook and other savings rates; and (3) it does not present different rates for different loan maturities.

The following table demonstrates the historical spread between the cost-of-funds index and the applicable federal rate for varying maturities. You will note that the cost-of-funds index more closely tracks the 80% of the applicable federal rate figures than it does the 100% of the applicable federal rate figures.

INTEREST RATES, MONEY AND CAPITAL MARKETS
AVERAGES, PERCENT PER ANNUM

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985[F]	*
FSLIC COST OF FUNDS (COF)[A]	6.14	6.32	6.38	6.44	6.66	7.47	8.94	10.92	11.38	9.82	10.03	9.40	-
APPLICABLE FEDERAL RATES													
AFR Short-term[C]	6.73	7.61	7.50	7.16	6.38	7.85	9.23	11.04	14.16	13.90	10.25[A]	12.01	9.54
Spread v. COF	0.59	1.29	1.12	0.72	-0.28	0.38	0.29	0.12	2.78	4.08	0.22	2.61	0.14
AFR Mid-term[D]	6.71	7.55	7.77	7.62	6.91	8.00	9.05	10.96	13.76	13.94	11.25[A]	12.95	11.00
Spread v. COF	0.57	1.23	1.39	1.18	0.25	0.53	0.11	0.04	2.38	4.12	1.22	3.55	1.60
AFR Long-term[E]	6.62	7.59	8.02	7.94	7.46	8.20	8.99	10.88	13.25	13.72	11.56[A]	13.01	11.40
Spread v. COF	0.48	1.27	1.64	1.50	0.80	0.73	0.05	-0.04	1.87	3.90	1.53	3.61	2.00
80% AFR Short-term[C]	5.38	6.09	6.00	5.73	5.10	6.28	7.38	8.83	11.33	11.12	8.20[A]	9.61	7.63
Mid-term D	5.37	6.04	6.22	6.10	5.53	6.40	7.24	8.77	11.01	11.15	9.00[A]	10.36	8.80
Long-Term E	5.30	6.07	6.42	6.35	5.97	6.56	7.19	8.70	10.60	10.98	9.25[A]	10.41	9.12
110% AFR Short-Term C	7.40	8.37	8.25	7.88	7.02	8.64	10.15	12.14	15.58	15.29	11.28[A]	13.21	10.49
Mid-term D	7.38	8.30	8.55	8.38	7.60	8.80	9.96	12.06	15.14	15.33	12.38[A]	14.24	12.10
Long term E	7.28	8.35	8.82	8.73	8.21	9.02	9.89	11.97	14.58	15.09	12.72[A]	14.31	12.54
OTHER RATES													
Federal Funds, effective rate	10.50	5.82	5.04	5.54	7.93	11.19	13.36	16.38	12.26	9.09	10.23	8.58	
One-year Treasury Bill	7.70	6.28	5.52	5.71	7.74	9.75	10.89	13.14	11.07	8.80	10.89	9.86	
Five-year Treasury	7.80	7.77	7.18	6.99	8.32	9.52	11.48	14.24	13.01	10.80	12.24	11.52	
Moody's Corporate AAA bonds	8.57	8.83	8.43	8.02	8.73	9.63	11.94	14.17	13.79	12.04	12.71	12.56	
FNMA securities G	9.43	9.37	9.11	9.05	9.90	11.94	14.34	16.59	14.97	13.16	13.65	12.07	
FHLMC securities H	9.71[J]	9.06[J]	9.10[J]	8.75	9.64	11.52	13.61	16.50	15.65	13.24	13.71	13.00[B]	
Six-month negotiable CDs[G]	9.98	6.89	5.62	5.92	8.61	11.44	12.99	15.77	12.57	9.27	10.68	9.60	

* AFRs in this column based on temporary regulation; where lower, they supersede statutorily calculated figures (as of April 2, 1985)
A Calculated as an average of actual semiannual figures
B As of February 1985
C Approximate statutory calculation using quarterly figures of appropriate 3-year Treasury obligations (Constant Maturity Yeild)
D Same as C using 5-year and 7-year Treasury obligations
E Same as C using 10-year, 20-year, and (where available) 30-year Treasury obligations
F As of April 2, 1985 (except as noted)
G Calculated as an average of actual quarterly figures
H Calculated as an average of weekly and daily average yields (except as noted)
J Calculated as an average net yield of whole loans

4-11-85
Real Estate Finance Division

The applicable federal rate was the index chosen by Congress to apply to all "adequate" interest tax rules including those applicable to real estate. We believe that 80% of this rate is needed by the industry as an alternative to unaffordable third party institutional lender rates. The cost-of-funds index, or some other index, may be advanced by some as a substitute for the applicable federal rate and may be acceptable -- but only so long as the resulting rate is comparable to 80% of the applicable federal rate.

2. Blending of Interest Rates

The NATIONAL ASSOCIATION OF REALTORS® believes that the test rates above and below the threshold for small and large transactions should be blended when seller financed transactions exceed that threshold. We contend that the threshold should be $4 million, however, for whatever level Congress determines the threshold to be, we support the blending method that exists in the "stopgap legislation" and in S. 729. The blending method in both these measures employs a simple averaging technique that protects sellers who finance an amount slightly above the threshold from having the entire amount of the transaction unfairly subjected to the test rate for large transactions. In other words, the amount below the threshold always qualifies for 9% financing.

The Ways and Means bill, on the other hand, contains a complex method of blending that phases out the test rate treatment for small transactions the more the seller financing exceeds the threshold (known as the "dollar for dollar" phaseout). Specifically, the bill provides a 9% test rate for seller financing amounts up to $2 million and a test rate of 100% of the applicable federal rate for amounts above $4 million. Between $2 million and $4 million, the dollar for dollar phaseout is applicable, so that for every dollar of financing above $2 million, the bill reduces the amount of seller financing treated at the 9% test rate by that amount. As a result, on $3 million of seller financing, only $1 million would have a test rate of 9% while the $2 million balance would be required to carry interest equal to 100% of the applicable federal rate.

We consider this provision unnecessarily complex and overly restrictive of the 9% test rate treatment. If a 9% test rate is thought appropriate for $2 million of seller financing, then it should be no less appropriate simply because more than $2 million of seller financing is involved in the transaction.

3. Accounting Methods

The NATIONAL ASSOCIATION OF REALTORS® agrees with Treasury that the mismatching of reporting of interest income and deductions by a seller and a purchaser in a seller financed real estate transaction creates the potential for tax abuse. However, we disagree with the solution that Treasury recommended for the problem and which was ultimately included in the Deficit Reduction Act. Treasury convinced Congress in the 1984 Tax Reform Act that the mismatching of income issue was best remedied by extending the original issue discount (OID) rules to seller financed real estate transactions. The OID rules basically require the seller to account for interest income on the accrued method of accounting. The rules require that the amount of accrued income be at least equal to 110% of the applicable federal rate.

The complexity created by the coupling of OID (accrual accounting) and imputed interest (110% of applicable federal rate) is mind-boggling. In a typical real estate transaction, the seller is concerned with the time value of his proceeds and liabilities. For example, to determine the attractions of an offer, a seller has to determine the net effect of having to recognize a certain amount of income in year one for tax purposes as opposed to receiving it years later. This net effect must be determined by taking into account a number of factors that affect the tax liability of a transaction including depreciation, capital gains and interest income. The OID provisions require that interest income be considered for tax purposes as having been received whether the buyer pays it or not and results in a recasting of depreciable basis and, obviously a reallocation of basis between land and the structure. Several respected economic analysts that we have contacted have found the OID provisions extremely difficult to understand and in many cases give different resulting offers to the same transaction. This complexity will discourage transactions and thus are undesirable for optimum economic well being.

The NATIONAL ASSOCIATION OF REALTORS® supports the provision in S. 729 that exempts seller financed transactions below $4 million from the OID rules. This bill instead solves the mismatching of income and deduction problem by requiring that both the purchaser and seller use either the cash method or the accrual method of accounting. The result -- the potential abuse is stopped without the unnecessary and undesirable complexity.

The Ways and Means bill is consistent with the position proposed in S. 729 and exempts "smaller-scale" seller financed transactions from the OID rules, but only for amounts below $2 million. We believe that in the interest of simplicity the threshold level should be $4 million. Particularly because raising the threshold to $4 million involves no additional revenue loss since the matching accounting method requirement in S. 729 eliminates potential abuse.

The NATIONAL ASSOCIATION OF REALTORS® is willing to work with the Treasury Department and Congress to rectify any remaining problems created by these few instances where abuse can still occur despite the matching requirement (i.e., when one of the parties to the transaction is a tax-exempt or charitable organization).

4. Assumptions/Wraparound Loans

The NATIONAL ASSOCIATION OF REALTORS® does not believe that the imputed interest rules should apply to a transaction simply by reason of a loan assumption. The rationale behind the exemption for loans assumed or taken subject to is that those lending transactions were originally contracted for under a different set of imputed interest rules and should not be forced to run the gauntlet of a new set of imputed interest rules and OID provisions that could force the parties to renegotiate the terms of the loan. The House bill recognizes this logic and exempts assumptions from the imputed interest provision. Further, we do not oppose applying the rules to wraparound or other all inclusive debt instruments, but we suggest that the imputed interest rules should not be measured against the interest rate in the wrap note, but should be tested against the actual rate of return which the seller receives on the equity portion of the wrap note.

We believe this formula produces a balanced and sensible result in establishing the actual cost of funds and, hence, the true yield to the seller. These rules are illustrated in the following example.

EXAMPLE: Real estate is sold for a total purchase price of $2.5 million. The purchaser makes a downpayment of $500,000 and issues a wraparound mortgage and note to the seller for the balance of $2 million. Interest accrues on the $2 million wraparound note at the rate of 10 percent per annum. In addition, the seller must make payments on an underlying obligation of $1 million at an annual rate of 8 percent interest. Since the seller receives from the purchaser $200,000 in interest per annum on the wraparound note and makes payments of $80,000 to the previous owner on the underlying obligation, the seller realizes a net yield of $120,000 annually from the wraparound note.

This amount represents a return of 12 percent to the seller on his equity of $1,000,000, which equals the amount of the underlying obligation to the prior owner. In this example, the annual return to the seller on his equity is 12%, which would be applied in determining whether the test rate was met. In this example, the return of 12 percent would satisfy the test rate of 9%. Hence, the OID and imputed interest provisions would not apply to the transaction.

5. Capital Loss Situations

Investment assets such as non-productive vacant land held primarily for appreciation in value, defined as "capital assets" (Sec. 1221 IRC), are non-depreciable and any loss realized by a taxpayer upon sale is deductible only to offset up to $3,000 of otherwise taxable income per year.

Further, the current law $10,000 limit on investment interest deduction applies directly to capital asset real estate deductions.

Clearly, the effect of imputing interest to the sale of a real estate Sec. 1221 capital asset is to recast payments to be more interest and less principle. Because of current law's $3,000 limit on annual capital loss deduction, recasting a lower principal amount will increase the amount of loss which the investor can't claim as a deduction. Further, the imputation of interest on capital assets could result in no deduction for the resulting higher interest payment because of the investment interest limitation rules.

These two situations -- an annual limit of $3,000 for capital losses and the investment interest deductibility limit -- we believe creates an inequitable result. We believe that at a minimum the following should be done to protect investor taxpayers.

1. Treat the imputed portion of capital loss (i.e. the increased loss resulting from imputation) as an ordinary loss currently deductible; or

2. Increase the investment interest deduction exemption of $10,000 in excess of investment income by the precise amount of increased interest deduction resulting from application of the imputed interest rules.

We urge Congress to act quickly and enact the above outlined solution to the imputed interest controversy before July 1, 1985. We would be pleased to answer any questions that the Committee might have on this subject.

Revenue Estimates of Changes in Imputed Interest Rules Included in the Tax Reform Act of 1984

Congress has estimated that the changes in the imputed interest rules affecting both seller financing and assumptions of existing financing included in the Tax Reform Act of 1984 would raise $2.2 billion of additional revenue over the 1985 to 1987 period (an average of $0.77 billion per year). As is typical of such revenue estimates this figure is based on static analysis. That is, different tax rules are applied to estimates of future levels of economic activity without taking account of the impact those different tax rules would have on the future levels of economic activity. In contrast, dynamic analysis does take account of the impact of the proposed tax law changes on the level of economic activity. Consequently, dynamic revenue estimates can be and frequently are substantially different from static revenue estimates. Using dynamic analysis it can be demostrated that the net revenue gain to the federal government of these pending imputed interest rules changes is quite likely to be negative.

A. Income Producing Property (Multi-family, commercial, and industrial)

The current stock of these types of properties is estimated at $3 trillion. It is estimated that about 3.5 percent of this stock turns over each year, putting annual sales at about $105 billion. Based on surveys of members of the NATIONAL ASSOCIATION OF REALTORS®, seller financing and assumptions of existing loans is involved in nearly 50 percent of the sales of these types of properties, suggesting that about 30 percent or $31.5 billion of these sales would be lost due to these rules changes. Analysis suggests that the contribution to GNP of these sales is about 15 percent of the dollar volume of sales, resulting in $4.73 billion of lost GNP. Federal revenues represent about 20 percent of GNP, resulting in about $0.95 billion of lost federal revenues.

B. Principal and Non-Principal Residences

Data indicates that just 2.5 percent of the sales of existing single-family sales are for properties costing $250,000 or more. At an average price of $400,000 and the long-run average of existing home sales at 3 million per year, that represents $30 billion of annual sales in this category of properties. It is estimated that 15 percent or 11,250 sales valued at $4.5 billion would be lost due to the imputed interest rules changes affecting seller financing and assumptions. In the case of single-family homes, the contribution to GNP is 20 percent of sales volume. Consequently, the loss of GNP is $0.9 billion while the loss of federal revenues is about $0.18 billion.

C. Farms

According to the U.S. Department of Agriculture about 0.4 percent of the 2.4 million farms in the U.S. are valued at $1 million or more. That means that about 10,000 farms with an average value of about $1.5 million would be affected by the proposed imputed interest rules affecting seller financing and assumption. The historical turnover rate for farms is about 2 percent, putting annual sales in this price category at about $0.3 billion. About 40 percent of farm sales are seller financed while another 20 percent involve assumptions. Analysis suggests that half of these sales (30 percent of all sales) would be lost for a total lost sales volume of $0.09 billion. The contribution of farm sales to GNP is estimated at 10 percent of sales volume. Therefore, lost GNP is estimated at $0.009 billion while the loss of federal revenues is about $0.0018 billion.

Table 1 summarizes the annual loss of GNP, jobs, federal revenues, and state and local revenues from the imposition of these more restrictive imputed interest rules. In regard to federal revenues, this loss must be netted against the expected increase in revenues. Of course, with a lower level of economic activity, the dynamic gross revenue gain will be less than the static gross revenue gain. Table 2 presents these alternative gross revenue estimates and demonstrates that the net revenue position of the federal government is likely about -$0.59 billion per year. At projected inflation rates it is quite likely that over the 1985 to 1987 period the net federal revenue loss would approach $2 billion.

Table 1

Estimated Annual Loss of GNP, Jobs, Federal Revenues, and State and Local Revenues Resulting From Proposed Changes in Imputed Interest Rules

Property Category	GNP (billions)	Jobs	Federal Revenues (billions)	State and Local Revenues (billions)
Multi-family, Commercial and Industrial	$4.73	94,600	$0.95	$0.61
Principal and Non-Principal Residences	$0.9	18,000	$0.18	$0.12
Farms	$0.009	180	$0.0018	$0.0012
Total	$5.639	112,780	$1.132	$0.7312

Source: NATIONAL ASSOCIATION OF REALTORS®

Table 2

Determination of Net Federal Revenue Position from Proposed Imputed Interest Rules Changes

Annual Static Gross Revenue Gain	$0.77	billion
Annual Dynamic Gross Revenue Gain	$0.54	billion
Annual Dynamic Gross Revenue Loss	$1.32	billion
Annual Dynamic Net Federal Revenue Position	-$0.59	billion

LOSS OF GNP, JOBS, AND TAX REVENUES BY STATE

STATES	GNP	FULL-TIME JOBS	TAX REVENUES
Alabama	$103,813,360	2,076	$34,604,453
Alaska	8,165,814	163	2,721,938
Arizona	37,031,819	741	12,343,940
Arkansas	72,143,134	1,443	24,047,711
California	591,980,354	11,840	197,326,785
Colorado	75,846,621	1,517	25,282,207
Connecticut	91,721,497	1,834	30,573,832
Delaware	15,828,835	317	5,276,278
District of Columbia	23,038,318	461	7,679,439
Florida	144,548,418	2,891	48,182,806
Georgia	163,015,625	3,260	54,338,542
Hawaii	7,014,251	140	2,338,084
Idaho	16,247,031	325	5,415,677
Illinois	283,619,548	5,672	94,539,849
Indiana	169,808,637	3,396	56,602,879
Iowa	52,368,351	1,047	17,456,117
Kansas	44,412,374	888	14,804,125
Kentucky	86,053,334	1,721	28,684,445
Louisiana	101,143,883	2,023	33,714,628
Maine	56,659,309	1,133	18,886,436
Maryland	76,778,201	1,536	25,592,734
Massachusetts	193,469,432	3,869	64,489,811
Michigan	221,564,206	4,431	73,854,735
Minnesota	102,092,428	2,042	34,030,809
Mississippi	71,582,813	1,432	23,860,938
Missouri	128,160,498	2,563	42,720,166
Montana	11,304,900	226	3,768,300
Nebraska	22,059,441	441	7,353,147
Nevada	6,971,410	139	2,323,803
New Hampshire	41,659,637	833	13,886,546
New Jersey	228,885,290	4,578	76,295,097
New Mexico	15,680,820	314	5,226,940
New York	426,266,917	8,525	142,088,972
North Carolina	268,483,236	5,370	89,494,412
North Dakota	7,209,447	144	2,403,149
Ohio	320,551,754	6,411	106,850,585
Oklahoma	62,952,939	1,259	20,984,313
Oregon	66,973,698	1,339	22,324,566
Pennsylvania	362,990,928	7,260	120,996,976
Rhode Island	48,729,823	975	16,243,274
South Carolina	110,064,415	2,201	36,688,138
South Dakota	6,271,247	125	2,090,416
Tennessee	162,630,821	3,253	54,210,274
Texas	429,512,815	8,590	143,170,938
Utah	23,416,877	468	7,805,626
Vermont	11,010,072	220	3,670,024
Virginia	143,008,473	2,860	47,669,491
Washington	89,232,786	1,785	29,744,262
West Virginia	41,373,259	827	13,791,086
Wisconsin	139,337,476	2,787	46,445,825
Wyoming	15,313,432	306	5,104,477
TOTAL	$6,000,000,000	120,000	$2,000,000,000

STATEMENT OF DAVID G. SMITH, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC

Mr. SMITH. Mr. Chairman, my name is David Smith. I am a home builder from McDowell, VA, and build residential and commercial properties in both Maryland and Virginia. I appear here today on behalf of the National Association of Home Builders, of which I am first vice president. NAHB represents more than 131,000 members and is pleased to have this opportunity to appear before the subcommittee to present its views and legislative proposals dealing with the imputed interest problem. In general, we do not quarrel with the principles that guided Congress in its deliberations over the issues of imputed interest last year. However, we think that Congress went too far. A primary concern of Congress was that, when taxpayers sold property, that they may achieve unwarranted tax benefits either by mismatching interest income and deductions or by manipulating the principal amount of debt or both. In the case of the typical home builder, this should not be a concern. Since the homes sold are inventory rather than capital assets, there is no incentive for the builder to understate interest. The builder's profits are characterized as ordinary income, whether or not the payments received are treated as interest. If the builder agrees to accept the moderate rate of interest, it is for the purpose of selling homes rather than to manipulate the tax system to his advantage. We believe that nonabusive transactions should be carved out of any stringent imputed interest rules, and we would be pleased to have our staff work with the subcommittee to accomplish this result. Our major concern about the imputed interest rules of 1984 Tax Act are that they build high interest rates into seller financing and would adversely affect investments and low-income housing. We believe that imputed interest legislation should have the following elements. For a smaller transaction, the required interest rate should be no higher than 9 percent. And for larger transactions, the required interest rate should be no higher than the Federal rate. In the interest of simplicity and to carve out smaller transactions, we feel that a $4 million threshold would be appropriate. Furthermore, we feel that loan assumptions should be outside the imputed rules, and finally, we suggest that the subcommittee consider a cap on interest rates or some other mechanism to protect sellers in times of rapidly increasing rates. Most of these elements are contained in Senate 729 introduced by Senators Durenberger, Symms, Pryor, Roth, and others, and cosponsored by Senators Boren, Grassley, Heinz, Armstrong, and others. We also appreciate the efforts of Senator Melcher who introduced Senate 217, Senator Dole who introduced Senate 71, and Senator Abdnor who introduced Senate 56. Before I conclude, let me note that the NAHB is very encouraged by the quick action taken by the House Ways and Means Committee in reporting an imputed interest proposal H.R. 2475. We also hope for quick action on the Senate so that the matter can be resolved before the July 1, 1985 expiration date of the temporary stopgap legislation. We look forward to working with the subcommittee and the full committee in order to accomplish this task. And I thank you for the opportunity to appear here before you this morning.

Senator CHAFEE. Thank you very much, Mr. Smith. Mr. Wechsler.

[Mr. Smith's prepared statement follows:]

STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
before the
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE FINANCE COMMITTEE
UNITED STATES SENATE
on
TAX TREATMENT OF IMPUTED INTEREST ON
DEFERRED PAYMENT SALES OF PROPERTY

May 20, 1985

Mr. Chairman and Members of the Subcommittee:

My name is David C. Smith. I am a homebuilder from McDowell, Virginia, and build residential and commercial properties in Maryland and Virginia. I appear here today on behalf of the National Association of Home Builders (NAHB), of which I am First Vice President. NAHB, which represents more than 131,000 Members, is pleased to have this opportunity to present its views on the imputed interest and original issue discount (OID) rules enacted in the Deficit Reduction Act of 1984 (DEFRA) and the stopgap legislation that is due to expire on July 1, 1985.

Let me note at the outset that NAHB generally supported deficit reduction legislation last year, even though it significantly increased taxes upon the real estate industry. However, a major concern for us was the OID provisions and the related imputed interest changes. We are concerned with the effect of these changes upon the sales of homes, raw land, multifamily and commercial structures, family farms, and small businesses.

Seller-financed installment sales of property have become an increasingly popular alternative to commercial financing. In order to consummate sales, parties dealing at arms-length in such transactions often are willing to negotiate interest rates that are lower than those charged by commercial lenders. Many sales of property never would occur without this ability to negotiate lower interest rates. The effect of DEFRA's modification of the OID rules and imputed interest rules is to force parties dealing at arms-length to negotiate interest rates that are equal to, or higher than, commercial rates, or else face adverse tax consequences. These provisions severely will impair the ability of many property owners to sell their property during times of high interest rates.

NAHB, therefore, believes that Congress should re-examine the entire issue of imputed interest and OID. We are pleased that the Subcommittee on Taxation and Debt Management is conducting hearings on the subject, and are encouraged by the Finance Committee Chairman's expression of confidence that a solution can be worked out to protect homeowners, farmers, ranchers, and small business owners. Futhermore, we hope to work with the Subcommittee and the full Committee, in a constructive and responsible manner, in order to devise a workable solution to the problems surrounding deferred payment sales of property. In addition, we are encouraged by the rapid action taken by the House Ways and Means Committee, and hope that this signals final action on the issue no later than July 1, 1985, the expiration date of the temporary, "stopgap" legislation.

At a minimum, NAHB believes that the DEFRA rules should be revised substantially. For example, we feel that a cap (perhaps 12 percent) should be placed as an upper ceiling for OID and imputed interest rates. Alternatively, a method could be provided to prevent the mandated interest rate from rising too sharply from one period to the next. Moreover, we believe that the test interest rate should be no higher than 9 percent or 80 percent of the Applicable Federal Rate (AFR) and that the imputed rate should be no higher than 100 percent of the AFR. Furthermore, we feel that a $4 million threshold would be appropriate for purposes of simplicity. Finally, we believe that realistic dollar exemptions should be provided for transactions involving sales of homes, raw land, multifamily and commercial structures, family farms, and small businesses. We support S.729, introduced by Senators Durenberger, Symms, Pryor, Roth, and others, which contains many of these elements.

I will now discuss, in greater detail, the tax treatment of imputed interest on deferred payment sales of property.

I. OID and Imputed Interest Rules

OID

DEFRA modified and expanded the OID rules of prior law. Most significantly, it extended those rules to debt instruments that are issued for property, where neither the instrument nor the property received for it is traded publicly, and to obligations issued by individuals. The new rules, thus, apply to any debt instrument (bond, debenture, note, or other evidence of indebtedness) issued in exchange for real estate, machinery, or other property.

price of an obligation and its stated redemption price at maturity is included in the income of the seller (as interest income) and generally is deductible by the borrower (as interest expense) under a mandatory accrual method of accounting and utilizing the constant interest rate method of allocating interest over the term of the contract. An obligation's issue price is its stated principal amount, unless there is inadequate stated interest. The stated redemption price at maturity is the total amount, including interest, which is payable at maturity reduced by any interest unconditionally payable at a fixed rate, at fixed periodic intervals of one year or less, during the entire term of the debt instrument.

DEFRA requires that where a debt instrument is issued for nontraded property, the stated principal amount of the obligation must be tested by discounting all payments to be made at a rate of 110 percent of the AFR. If the stated principal amount is greater than the test amount, then an imputed principal amount is derived by discounting all payments to be made under the instrument at a rate equal to 120 percent of the AFR. The resulting OID must be amortized over the life of the instrument by both the issuer (buyer) and holder (seller).

Several types of transactions are excluded from the new OID rules. These transactions include the following:

- Transactions involving total payments (principal and interest) of $250,000 or less;
- Transactions in which all payments are due within six months or less after the date of sale or exchange;
- Sales by individuals of their principal residences;

- Certain sales of farms by individuals and small businesses (if the sales price does not exceed $1 million);
- Sales of certain patents;
- Certain sales of land between related parties ($500,000 limitation); and
- Obligations containing a de minimis amount of OID.

In addition, there is a special rule for personal use property that exempts cash-method issuers (but not holders) of debt instruments issued in exchange for property substantially all of which will not be used by the issuer in a trade or business. Thus, such issuers may claim interest deductions only for amounts actually paid during the taxable year. Suppose a home buyer issues a note for the purchase of a new home and the note does not provide for adequate interest. What this provision means is that while the builder may have phantom income to report due to the imputation of interest, the home buyer will not receive a corresponding deduction. Clearly, this amounts to mismatching in favor of the Treasury.

The first OID exception I mentioned (transactions involving total payments of $250,000 or less) is not as generous as it appears. In the context of today's market, it would exclude from the OID rules a mortgage of about $65,000.

Basically, the OID rules seek to recharacterize the principal and interest elements of a deferred payment transaction to take into account the payments based upon a discount rate that is driven by the government's cost of money. These rules apply concepts to private transactions that are similar to concepts that are applied to publicly traded securities, such as zero coupon bonds. They impose a system of tax accounting for interest and principal payments that often may be different from the agreed upon interest and principal payments that the parties to a transaction themselves negotiate. Under the OID rules, payments of principal are recharacterized as interest, and, therefore, treated as income to a seller or lender if the stated interest rate falls below the statutory rate. Generally, the debtor-purchaser will receive a corresponding deduction.

Congress was concerned that under the law prior to DEFRA it was possible for taxpayers in a sale of nontraded property for nontraded debt to achieve "unwarranted" tax benefits either by mismatching interest income and deductions or by manipulating the principal amount of the debt, or both. Significant tax advantages could be achieved by characterizing a transaction as involving a lower rate of interest and a larger loan principal amount. If recognized for tax purposes, the mischaracterization of interest as principal resulted in an overstatement of the sales price and tax basis of the property. If the property was a capital asset in the hands of the seller, then the seller was able to convert interest income (that is, ordinary income) into capital gains taxable at preferential rates. Moreover, if the property was depreciable in the hands of the purchaser, the increased basis enabled the purchaser to claim larger cost recovery deductions. In the case of the sale of a new home where financing is provided by the builder, these incentives to disguise interest as principal for tax advantage are not present. The builder cannot report the profits on sale of the home as capital gain and an owner-occupant cannot depreciate the home.

In general, we do not quarrel with the principles that guided Congress in its deliberations over the OID rules. We do, however, think that Congress went too far in its attempt to close perceived abuses, and swept within DEFRA's net a multitude of legitimate, non-abusive transactions. For example, take the case of the typical home builder. The homes he sells are inventory, rather than capital assets in his hands. Thus, there is no incentive for the builder to understate interest since his gain is ordinary income, whether or not the payments he receives are characterized as interest. If the builder agrees to accept a moderate rate of interest, it is for the purpose of selling homes rather than an attempt to manipulate the tax system to his advantage.

I know of a builder who provides seller financing to his buyers for a relatively short period because he finds that, for psychological or economic reasons, home buyers resist paying interest above certain levels. The builder provides 10-year interest-only financing at a rate low enough to induce the buyer to purchase a home. The idea behind this type of financing is that once mortgage rates come down to a reasonable level, the buyer will refinance the loans. This situation does not involve any adverse tax gimmicks yet the builder is adversely affected. DEFRA would require the interest to be imputed at the 120 percent rate. The builder would be forced to accrue the "deemed interest" over the 10 year period of the note, even though he receives no cash with which to pay the tax on that additional interest. We believe that it is inequitable to tax this type of seller before he receives the cash to pay the tax. This particular problem would not occur if the test interest rate was set at a reasonable level. Neither would this problem occur if the OID exception for sales of principal residences applied to sales of new homes, as well as to resales of used homes. Because of high mortgage interest rates, the builder I have described must do what many individual home sellers must do, namely, carry some of the financing himself until the buyer can refinance elsewhere at a lower market rate. We feel that as a matter of equity the two types of sellers should be treated the same.

To summarize, in the situation I just described, the builder currently reports the actual interest received from his buyer and the buyer deducts the interest when he pays it. Both of these events occur in the same year so that there is no mismatching of income and deductions. Nonetheless, the OID rules would convert part of the principal amount of the purchase price of the residence into additional imputed interest and force the builder to accrue that interest before the buyer pays it. Furthermore, as I noted previously, the home buyer is denied any deduction for the imputed interest that he is deemed to pay. If this type of transaction is to remain subject to the OID rules, we believe that the denial of this deduction to the home buyer is unwarranted.

Deferred Payment Sales of Property (Code section 483)

DEFRA provided that, for sales closing after 1984, Code section 483 applies only to sales that specifically are excepted from the OID rules (for example, sales of principal residences, certain sales of farms, and other transactions involving total payments of $250,000 or less).

Furthermore, DEFRA revised Code section 483 as follows:

- The interest rates and interest imputing calculations used in Code section 483 have been conformed to the new rates and imputing methods that I previously discussed used for obligations subject to the OID rules.
- The new Code section 483 testing and imputing rates do not apply to sales of principal residences by individuals to the extent that the sales price does not exceed $250,000, nor to certain sales of farms. Rather, discount rates provided by old section 483 are used (9 percent test rate, 10 percent imputing rate), but both the test and imputing rates are compounded. (For the period January 1 through June 30, 1985, the 9-percent and 10-percent rates apply to loans with stated principal of up to $2,000,000.)

Stopgap Legislation

The stopgap legislation (P.L. 98-612) provides that for sales or exchanges occurring from January 1, 1985 through June 30, 1985, the test interest rate is 9 percent and the imputing rate is 10 percent, to the extent that the stated principal amount of all debt obligations issued as part of the transaction (or a series of related transactions) do not exceed $2 million.

If the obligations issued in a transaction exceed $2 million, the test rate is a blend of 9 percent and 110 percent of the AFR. The imputing rate is a blend of 10 percent and 120 percent of the AFR.

We believe that the stopgap legislation is far better than the DEFRA rules it replaces. While we would hope to see permanent rules in place by July 1, 1985, if this is not possible, we would hope that the stopgap rules be extended for as long as it is necessary to work out a satisfactory solution.

III. Implications of DEFRA OID and Imputed Interest Rules

First, the DEFRA rules build high interest rates into most private deferred payment transactions. Instead of imposing a Federal rate when interest rates are fixed by the parties below a certain level, DEFRA requires that rates be established above the Treasury's cost of money at the time of the transaction. This ensures that negotiated private sales, except where exempt from the imputed interest rules, always will be at a rate higher than the Federal rate. Because the interest rate must be the rate that is in effect at the time the transaction is negotiated, this rate will vary. In a high interest environment, privately negotiated sales no longer will be a mechanism to bring down interest rates. Privately negotiated interest rates, instead, will follow the Federal Government's cost of funds.

This represents a major shift in philosophy. During the period of high interest rates in 1981 and 1982, private seller-financed sales in the real estate industry were a major way to continue real estate activity, even though public rates were at the 18 to 20 percent level. New home sales, sales of used homes, and sales of commercial and multifamily projects survived generally because sellers and buyers were willing to negotiate based upon interest rates that were well below the market. This provided a benefit to the nation's economy by keeping some new construction alive and by unlocking capital into the system.

Second, under current conditions, interest rates for seller-financed transactions will increase. Homebuilder-financed sales of individual homes involving total payments of principal and interest exceeding $250,000 fall within the new OID and imputed interest rules. Thus, in order to avoid the amortization of OID by both buyer and seller or the imputing of interest, a home builder must charge a rate of interest on an installment obligation issued by a buyer that is equal to, or greater than, 110 percent of the AFR. Since most home mortgages exceed 15 years, the AFR applicable to home builder-financed sales of homes generally will be the Federal long-term rate. For the month of April, 1985, the long-term AFR (computed on an annual basis) is 12.21 percent. 110 percent of 12.21 percent is 13.48 percent. Thus, a home builder would have to charge a rate of 13.48% in a seller-financed home sale in order to avoid the adverse consequences of the OID and imputed interest provisions. This high rate undoubtedly would dampen builder-financed sales of new homes. To continue further with this example, if the builder failed to provide for interest at least at the 13.48 percent rate, interest would be imputed at a rate of 14.74 percent. This, indeed, would be a high price to pay for the sales of new homes. I might add that the current VA interest rate is 12 1/2 percent. Thus, a builder would have to pay a price for offering VA financing.

The underlying purpose of home builder-financed sales of homes when commercial interest rates reach a high level is to produce a negotiated interest rate that is lower than such rates. However, the new OID and Code section 483 imputed interest rules would impose an even higher rate in home builder-financed sales. It seems to us that this result undermines the entire concept of contractual terms and obligations freely negotiated at arm's-length.

Third, the new rules will increase interest rates that ultimately will be passed on to consumers. This will show up in many different ways. For example, multifamily projects will require a higher rate of interest when deferred payment transactions are entered into. The result will be an increased debt service burden for the project, thus, requiring higher rents to make the project feasible.

For purchasers of new homes, the effect will be an increase in the cost of those homes. This is because land sales often involve privately negotiated seller financing. The deferred payment provisions also will add significantly to the home builder's cost of development and construction of new homes. Typically, a builder will purchase raw land for the purposes of development and construction of housing tracts in an owner-financed installment transaction. The financing for such a transaction generally is fixed in the neighborhood of 10 to 12 percent.

The new OID and imputed interest rules will require an added interest cost that will have to be made up by the home builder in the price at which he sells newly-constructed homes. Accordingly, the new deferred payment rules well may drive up the price of new homes. Furthermore, the interest cost of carrying land during construction will increase. The end result is that builders, in order to maintain current project margins, will have to raise the cost of the final product to the consumer.

Fourth, the new rules will virtually eliminate investment in low-income housing. The housing stock for low-income renters will be forced to decline gradually because many HUD low-income projects do not have adequate reserves for repairs and maintenance. One of the major benefits of the Economic Recovery Tax Act of 1981 was the infusion of capital into low-income projects and the attraction of new investors. These investors were seeking tax benefits associated with real estate investment and were willing to place new capital into projects that were badly in need of refurbishing. The HUD guidelines required additional repairs, maintenance, and higher levels of reserves. Because the income from these projects was not adequate to support the debt service, the transaction often involved negotiated agreements between buyers and sellers for low interest purchase money loans in which the final payments of interest would not be made until sometime in the future. This resulted in cash flow to support the debt service.

The OID rules, which will reduce the principal for purposes of cost recovery deductions and require sellers to recognize phantom income, will mean that these types of transactions no longer will be attractive to investors. The result will be that many HUD properties will continue to decline and HUD may often have a higher inventory that will be very costly to maintain and operate.

NAHB urges the Committee to consider these problems very carefully as part of the potential OID revisions. In addition, we urge the Committee to investigate with HUD the implications of the new OID rules for the existing HUD assisted housing stock.

III NAHB Positions and Conclusions

The DEFRA provisions with regard to OID and imputed interest have created major problems both from a technical and a policy viewpoint. As I noted earlier, the provisions build high interest rates into privately negotiated transactions. Thus, NAHB believes that Congress should reconsider the entire issue. Ideally, NAHB would prefer that the DEFRA OID and imputed interest provisions be repealed, and we appreciate the efforts that Senator Symms and others have made in that regard. Although short of repeal, we also are encouraged by the efforts of Senator Durenberger and others on the Committee to find a workable solution to the problem, and commend them for their action.

At a minimum, we believe that a more realistically designed provision should be enacted. The test for imputed interest rates is too high. We feel that the test rate should be set no higher than 9 percent or 80 percent of the AFR and the imputed rate should be set no higher than 100 percent of the AFR. Furthermore, a cap should be placed upon the upward escalation of the imputed interest rate. We feel that a cap of 12 percent would be appropriate.

We feel that it would be appropriate for the Committee to retain the threshold concept, as embodied in the stopgap legislation. However,.we suggest that a higher threshold ($4 million) be adopted. We feel that a higher threshold is appropriate both for the purpose of accomodating larger projects and in the interest of simplification. Furthermore, we believe that if a permanent threshold is adopted, the legislation and committee reports should make it clear that the threshold amount applies, in the case of a home builder, to each separate residence, cooperative, or condominium unit sold to a separate buyer. This would clarify that sales by a home builder of all the houses in a single development, or of all the cooperative or condominium units in a single building, to persons who are unrelated to one another are not to be aggregated.

We also feel that assumptions of loans, whenever they originated, should be excluded from the OID and imputed interest rules, unless the assumed loans are substantially modified. Neither the buyer nor the seller have any control over the interest rate provided for in an assumed loan.

Furthermore, we believe that more consideration should be given toward targetting OID and imputed interest rules to transactions that the Congress perceives to be truly abusive (that is, to transactions that are driven purely by tax considerations with little, if any, economic rationale). As I pointed out earlier, for example, we do not believe that sales of homes by home builders are the type of transactions that the Congress perceived to be abusive. In fact, it would appear that all nondepreciable property could be excluded from the OID rules without violating the concepts that motivated the Congress in enacting DEFRA. Several technical problems that we have not discussed in the interest of time (for example, contingent and variable interest rate loans) would disappear if the Congress settled upon a reasonable safe-harbor interest rate.

Finally, we believe that the issues of OID and imputed interest should be kept separate from the issue of builder bonds. One of the early compromise proposals in the Senate last year did deal with builder bonds. Appropriately, the builder bond question was not included in the stopgap legislation. Since the two issues deal with separate problems, we feel that it is appropriate for Congress to consider them separately.

Thank you for the opportunity to present our views. I would be happy to answer any questions you may have, and I look forward to working with the Congress to fashion appropriate OID and imputed interest rules.

STATEMENT OF STEVEN A. WECHSLER, VICE PRESIDENT AND GENERAL COUNSEL, NATIONAL REALTY COMMITTEE, WASHINGTON, DC

Mr. **Wechsler**. Mr. Chairman, my name is Steven Wechsler. I am vice president and general counsel of the National Realty Committee. The National Realty Committee is a trade association which consists of some of the Nation's principal owners, developers, financiers, and builders of real property, particularly commercial real property. In 1984, the National Realty Committee supported the bulk of the 1984 Tax Act changes affecting real estate. Although we had certain concerns respecting many of the OID and imputed interest changes, NRC generally supported the intent of Congress: to stop abusive, tax-motivated transactions. However, some of those concerns are still with us today, partly because of the complexity of the old rules and partly because we believe current law mandates an overstated test interest rate. NRC has a number of recommendations to rectify these problems. However, before doing that, we should recollect what brought the 1984 OID rules and imputed interest rules to us. One abuse was a mismatch of accounting methods between a cash basis seller and a accrual basis buyer where if one party to a transaction was deducting interest, the opposite party was not simultaneously claiming any income. That has been taken care of in the 1984 act, and I think industry in general supports that approach and is tired of the numbers of transactions that went on that abused the accounting methods permitted in the code. Another abuse prior to 1984 was the noneconomic computation of interest. People using simple interest, the rule of 78's or other such approaches would understate interest. That is out now under the 1984 act through sections 1274 and 483 of the code, which requires economic accrual and compounding. The third abuse prior to 1984 was the overstatement of principal relative to interest. And to the degree that the overstatement of principal leads to the overstatement of basis for depreciation and the understatement of interest, that can be a concern for the Treasury and the Congress because an inflated basic for depreciation may understate interest expense and overstate depreciable basis to the buyer and understate interest income and overstate capital gain to the seller. Now, what was Congress' solution? NRC thinks Congress acted properly in two out of three of those matters. The third item, in terms of setting the test rate for interest, which really defines the value of the property in a seller-financed real estate transaction, we think, was overly drawn. One reason we think so is that the theory underlying these rules sets the value of the property, assuming it was 100-percent financed, to the same behavior economically as a bond—as a Treasury bond—and that doesn't bear witness to the facts. When interest rates are high, they largely reflect high inflation or high inflationary expectations. When you have that with real income-producing assets, such as real estate, that don't have a fixed stream of payments—in fact, the rents can be increased as the leases expire—then the value of that property may likely continue to increase in inflationary times. Conversely, with a Treasury bond. the price or value of that bond will decline to bring up the yield to match other financial instruments. Because of this flaw in the theory underlying these rules when applied to seller financing and real estate, we think that as interest rates get higher, you need to alleviate some of the pressure these artifical rules will put on the marketplace. Otherwise, no sales will take place. The 110-percent rate which sets this value for tax purposes we think is too high. In fact, according to Barron's magazine which publishes commercial mortgage rates on a monthly basis, 5-year money was available cheaper than the test rate for large commercial transactions set by the existing OID and imputed interest rules. In fact, it was available at approximately 100 percent of the test rate. So, I think the facts bear out that 110 percent is much too stringent. In addition, many would argue that the test rate for seller financing should be lower than market rates for third party financing because there are not similar transaction costs involved in seller financing, and it is essentially a wholesale transaction. The lender in a seller financed transaction doesn't have to go out in the marketplace and borrow the money, as a bank or finance company does. In fact, the difficulty of setting this value through a test interest rate has been emphasized from 1983 on in hearings before this committee. Treasury's Tax Legislative Counsel Robert Woodward testified in 1983 that it was difficult to set value in these transactions and difficult to determine the right interest rate. In addition, it was borne out by Congress prior judgment: These types of seller-fianced real estate transactions were previously excepted from the OID rules. For 20 years we have had imputed interest rates which, stated roughly, were set at 9 percent. Treasury had the authority over those 20 years to change the rates. They did it twice over a 20-year period even when interest rates and inflation were very high. One wonders why it wasn't changed if it was such a tax abuse Particularly now that Congress has prevented the mismatch of accounting methods and in noneconomic computation of interest, we think there can be a little greater leeway. NRC would recommend something akin to an 80-percent test rate. If that is deemed too generous by Congress, there are some transactions that may be able to overstate principal more than others. And there are those where overstatement is deminimus or has no negative tax effect. We would recommend that those transactions where it is exceedingly difficult to overstate principal, even in an 80-percent versus 100-percent test rate, be carved out and subject to some lower rate, say 80 percent of AFR. Generally, transactions where the term of financing is shorter than, say, the recovery period of the property, or two-thirds of it, should get more lenient treatment. That was part and parcel of the Dole bill last year. In addition, if the accrual feature is not present or you substantially pay interest currently, you don't have the same capacities to overstate principal and therefore overstate depreciation deductions or capital gain. We would appreciate the committee considering some type of antiabuse governor so that those active in the industry can sell and buy real property with seller financing when interest rates go up very high, reflecting inflation and higher values of property. Thank you.

Senator **Chafee**. Thank you, Mr. Wechsler. Mr. Slesinger.

[Mr. Wechsler's prepared statement follows:]

STATEMENT OF THE NATIONAL REALITY COMMITTEE ON APPLICATION OF OID/IMPUTED INTEREST RULES TO OBLIGATIONS ISSUED FOR PROPERTY

Mr. Chairman. My name is Steven A. Wechsler. I am the Vice President and General Counsel of the National Realty Committee ("NRC"). My statement presents the views of the NRC on the application of the original issue discount ("OID") rules to obligations issued for property. NRC is a non-profit business league representing a significant and diverse cross-section of the real estate industry. NRC members include owners, operators and developers of all types of real estate throughout the United States. As a broad-based organization, NRC is concerned with the overall health and growth of the real estate industry.

NRC recognizes the reasons underlying the revision and expansion of the OID rules in the Tax Reform Act of 1984. During Congressional consideration of that legislation, NRC supported OID changes in principle. At that time, however, NRC expressed concern about the complexity and uncertainty of the OID rules. Last fall in P.L. 98-612, the Congress enacted transitional and grandfather rules delaying the full impact of the 1984 Act amendments but not addressing the substantial difficulties posed by the imputed interest rules. NRC believes that simplification and clarification of these rules is needed prior to the OID provisions' impending July 1, 1985 effective date. Legislation improving the OID provisions should be enacted promptly.

The OID rules should be amended in 3 general ways:

1. The OID interest rate structure should be simplified and the rates reduced.

2. Application of the OID rules should be clarified, particularly with respect to variable interest rates, contingent interest and assumed obligations.

3. The OID rules and other accounting provisions should be modified to recognize business practice and necessity where tax avoidance potential is insignificant or nil.

Interest Rate Structure

a. Simplification

The new OID imputed interest rules apply to a test rate of 110 percent and an imputation rate of 120 percent, where required, of the applicable Federal rate ("AFR"). There are three AFRs, one each for short-term, mid-term and long-term obligations. The statute bases the AFRs on the average of such rates for the six-month period ending on the immediately preceding September 30 or March 31. Because the AFR determined under the statutory rule may be based on rates in effect from 3 to 15 months before a transaction, the AFR may vary significantly from current market rates. The decline in interest rates from late 1984 into early 1985 has resulted in market rates in 1985 which are lower than the AFR determined under the statutory six-month method. To alleviate this problem, the Internal Revenue Service announced on February 13, 1985, that it would provide an alternative method of computing AFRs for the one-month period ending on the 14th day of the preceding month and announcing the alternative AFRs on approximately the 20th day of that month.

The alternate rate will be available for the two succeeding months. However, the alternate rate will be used only in lieu of a higher (but not a lower) rate computed on the statutory six-month basis.

NRC recognizes that provision of alternate monthly rates will reduce, although not wholly eliminate, the time-lag problem. The cost of more current AFRs under the present statute is increased complexity. As a result of this alternate system, several rates may apply within a given month. Taxpayers will have to select the AFR from two or more rates and use the 110 percent and 120 percent testing and imputation rates.

For example, a seller financing 10 million dollars of the purchase price of property in May 1985 for 6 years will compare four different rates to determine the AFR. The AFR will be the lowest of the six month mid-term rate published for January 1 - June 30, 1985 (13.37%), the mid-term rate for May (11.83%), the mid-term rate for April (11.84%), or the mid-term rate for March (11.30%). (See attached revenue rulings.) The March mid-term of 11.30% is the lowest and therefore the AFR. The test rate will be 110% of 11.30%, or 12.47%. The purchase money mortgage will bear adequate interest and avoid application of the OID imputed interest provisions if it bears stated annual interest of at least 12.47%.

NRC urges that the OID rules be simplified by repealing the statutory six-month base average and substituting monthly (or more frequent) determinations. In addition, to reduce computations further, a single test and imputation rate should be used.

The OID provisions in the 1984 Act and the interim legislation create relaxed or simplified tests or total exemptions from certain rules for loans for amounts below specified levels. NRC sees no principled reason for imposing different treatment on loans of different amounts. Nevertheless, as a practical matter, NRC has no objection to providing simplified rules for smaller loans, for example, those for below $2 or $4 million. However, even if small loans receive special treatment, NRC believes it imperative to simplify the OID rules for all loans, regardless of size, and particularly those not involving tax abuse potential as hereinafter described. (See page 7.)

b. Rate Reduction

NRC recommends that a rate below 100 percent, say 80 percent, of the AFR would serve to protect the fisc while allowing taxpayers to complete transactions which they consider desirable for business and economic reasons, even if concluded at a rate somewhat below the AFR.

The impact of the OID provisions on transactions becomes more severe as interest rates rise. Typically, interest rates increase directly in relation to inflation. Therefore, in periods when inflation causes high nominal interest rates, the

OID rules applying money market rates to deferred payment sales will have several objectionable results.

Applying high, inflation-driven interest rates to property transfers will serve to stimulate inflation further. Instead of only reflecting inflation, interest rates required by tax considerations will contribute directly to increase it.

The uniform application of high interest rates disregards the genuine business motivation behind transactions involving comparatively lower rates set for sound economic reasons and not for tax avoidance. Buyers simply will not pay interest currently at very high rates for property which is acquired for its inflationary appreciation potential but which lacks any significant current cash flow.

Clarification

The imputed interest rules, and their legislative history, provide little or no clear guidance concerning the treatment of several common business features of debt transactions: variable interest rates, contingent interest and assumed obligations. It would be remiss if reconsideration of the OID rules fails to address these common arrangements.

a. Variable Rates

Lending institutions, as well as many private lenders, frequently charge interest for their funds by reference to the prime rate of a major financial institution. Some lenders and borrowers seek to base their interest charges and costs by reference to objective public indexes or widely-traded debt instruments in order to facilitate hedging their respective positions.

NRC urges that variable rates be considered acceptable for purposes of meeting the OID testing requirements provided the variable rate stated in the contract -- (1) is pegged to an objective and publicly available rate or index which varies directly with changes in market interest rates, and (2) the initial rate established as of the contract date equals or exceeds the OID testing rate. For example, a variable rate determined by reference to the published prime rate of a large financial institution would be an appropriate interest measure.

b. Contingent Interest

Transactions may provide for interest which is stated and therefore measurable, but which is payable only if some contingency occurs. Typical contingencies are certain standards or levels of cash flow, receipts or similar items. In addition, a rate of interest might be stated but payment of part or all of such interest deferred until a specified contingency occurs. Because of restrictions on rent and on distributions, subsidized housing often lacks cash flow adequate to make full interest payments and frequently involves contingent, deferred interest.

NRC believes that applying the OID rules in their present form in the case of contingent, deferred interest payments is not feasible. NRC recommends that where deferral serves a business (and not a tax avoidance) purpose, both the payor and payee of such interest account for it for tax purposes under the cash receipts and disbursements method of accounting. For this cash accounting rule to apply, the contingency which would result in deferral must be genuine. In addition, a safe harbor could be created for contingent interest which is dependent on legitimate contingencies. Under such a rule, stated and contingent interest would together be treated as adequate interest provided (1) the stated interest rate is equal to a minimum percentage of the AFR, and (2) the combined value of the stated and contingent interest would be equal to 110% of the AFR.

NRC also believes that deferral of the payment of some portion of interest should be permitted in limited circumstances without subjecting an obligation to the imputed interest rules, provided the obligation's stated rate is adequate. NRC recommends that deferral of the payment of some interest should be permitted, without requiring application of the interest imputation rules to an obligation for up to two years after issuance of the obligation, provided the obligation requires current payment of a substantial portion of its stated interest. Requiring cash accounting by payor and payee might be appropriate in this situation as well.

It should be noted that a reduction in the OID rule test rate would alleviate the problems posed by contingent interest in the case of many transactions requiring both a stated, fixed rate of interest and a supplementary contingent percentage. The lower the test rate is, the greater would be the likelihood that the stated, fixed rate would be adequate to satisfy the test rate, making it unnecessary to apply the OID provisions to the additional contingent interest.

c. Assumed Obligations

NRC believes that if a debt obligation is assumed in connection with the sale or exchange of property, or if property is taken subject to a debt obligation, such assumed obligations should not be subject to the imputed interest rules provided the obligation is not modified in connection with the transaction. Neither the original bills nor the Committee reports on the 1984 Act applied the OID provisions to assumed obligations. The Conference Report, however, authorized regulations, similar to existing regulations under Code section 483, to apply the OID rules to assumed deferred payment obligations and assumed obligations to third-party lenders. Subsequent legislation added section 44(b)(5) to the 1984 Act to apply the OID rules to such obligations.

Applying the OID rules to assumed obligations will substantially alter many typical real estate transactions. Significant amounts of principal payments will be converted to interest. Depreciable basis will be reduced. Cost recovery deductions will be treated as interest expenses, subject to the Code's limitations on interest deductions. Amounts previously considered capital gain will become ordinary income.

Assumptions unaccompanied by any material change in the obligation are distinguishable from the creation of new obligations. A seller and purchaser entering into a new purchase money obligation are free to negotiate a principal amount and interest rate with or without reference to the then applicable Federal rates but, in transactions involving the purchase of property subject to existing obligations, the opportunity for conscious manipulation of relative principal and interest amounts is limited. The only alternative to closing the transaction subject to the existing obligation is to pay off such obligation in full, and even that option may be limited by any restrictions in the debt instrument against a free right to prepay. In addition, application of the OID rules to assumptions of pre-existing indebtedness reflects an attempt to fragment the value, and therefore the appropriate purchase price, of a parcel of real property separate and apart from the value inherent in any indebtedness then a lien against such property. Such fragmentation is contrary to all past practice, is inconsistent with the lack of any comparable fragmentation of other factors implicit in the overall value of commercial real property (such as the existence of long-term leases which may either enhance or depress the value of the property on an unencumbered basis), and is not needed to prevent any abuse. Where the debt instrument originally taken back by the seller bore an actual or imputed rate of interest then appropriate under either Section 483 or

Section 1274 of the Code at the time entered into (and in all cases where the instrument was created in exchange for money actually lent), there is no persuasive reason for imputing a readjustment in the interest rate merely by reason of a subsequent transfer or property subject to such obligation.

In addition, prescribing OID regulations for assumed obligations which follow all aspects of the present section 483 regulations would be unreasonable. The present section 483 regulations appear to assume static interest rates. They conflict with some purposes of the 1984 Act rules and make inappropriate distinctions. Under the present section 483 regulations, an obligation is treated differently upon its assumption depending upon whether or not it originally had adequate stated interest which would be subject to retesting upon assumption, while obligations which originally had interest imputed would not be subject to retesting.

NRC believes that 1984 Act section 44(b)(5), as well as the earlier Conference Report authorization to apply the OID rules to assumed obligations, is ill-advised and should be repealed. Nevertheless, in the event that any imputed interest rules are to be applied to assumed obligations, only the purchaser should be affected by such rules. Sellers should not be affected because they were subject previously to testing and interest imputation, if applicable, with respect to the obligation when they originally entered into it. Their legitimate expectations thereafter should not be upset.

In no event should the imputed rate for assumed obligations exceed the AFR. The rate imputed on an assumed obligation, at most, should bring the obligation up to the current market rate. Applying a "penalty rate" to assumed obligations is inappropriate. A buyer ordinarily had no control over the assumed obligation's original stated rate. Therefore, a buyer should not be subject to an imputed penalty rate merely because the original rate, set perhaps years earlier, falls below testing (or market) levels at the time of the assumption. Any new OID regulations should not adopt the unreasonable distinctions made by the present regulations under Code section 483.

While unnecessary complexity can be avoided by excepting real estate transactions involving assumed obligations for small amounts from the imputed interest rules, all assumed obligations for amounts in excess of a de minimus figure should be governed by the same rules. In this regard, obligations assumed in connection with real estate transactions should not be treated less favorably than obligations assumed in connection with other types of transactions.

Tax Accounting Modifications

The 1984 Act imposed new accounting rules on a range of transactions, including transactions between partners and partnerships, and between other related parties. Generally, these rules imposed consistent accrual accounting, frequently on an economic or OID basis, on payors and payees. NRC appreciates that under prior law some taxpayers had exploited the timing differences between the cash and accrual methods of accounting in structuring transactions between cash and accrual basis taxpayers which were abusive of the tax system and detrimental to the fisc. Clearly, NRC agrees, some anti-abuse measures were needed.

The new anti-abuse accounting rules, however, have greatly increased the complexity of tax accounting for many taxpayers. Some affected taxpayers now may find themselves accounting generally on the cash method but reporting separate transactions on the accrual method. Other accrual basis taxpayers may be reporting some transactions under the cash method upon payment or receipt.

For some taxpayers, accrual accounting will create significant economic hardships. Under the accrual method, some taxpayers will be required to report and pay tax on income which they will not in fact receive for years hence.

The across-the-board application of the new rules and the strong preference which they evince for the accrual method seem inappropriate and unnecessary. Many taxpayers with no tax-avoidance intent and many transactions totally lacking in tax-avoidance potential fall within their ambit. Taxpayers must learn and follow two (or more) different systems of accounting at the same time. The simplicity of the cash method has been supplemented, or in some cases replaced, by more difficult accrual principles.

Contrary to the policy apparently underlying the 1984 Act rules, accrual accounting is not superior to the cash method in all circumstances. As a theoretical matter, accrual accounting may provide a more accurate reflection of income. As a practical matter, however, accrual accounting would require many ordinary taxpayers long used to the easier cash method to master new and difficult principles and to keep more complicated records. Such a transition would be unduly burdensome for many taxpayers and in many cases unrewarding for the Treasury as well. The familiarity and ease of the cash method for many taxpayers should not be undervalued.

NRC believes that more exceptions from accrual accounting can be permitted without creating a danger of abusive tax shelters. NRC endorses the suggestion made by some legislators, that if both parties to a transaction agree to report payments and receipts on a cash basis, the accrual method need not be mandatory. NRC would not limit this cash basis election to small denomination loans, but would extend it to all loans. To insure that transferees of the original parties adhere to this bilateral election, it might be required that the election be expressly incorporated in the loan agreements.

If a bilateral election of cash method of accounting is allowed for only small transactions (or for none), NRC believes that other exceptions to mandatory accrual can be safely provided. The OID accrual rules were intended to prevent tax sheltering resulting from the overstatement of basis and concomitant increased depreciation deductions. Therefore, transactions which do not afford opportunities for such abuses should be excepted from mandatory accrual accounting. For example, purchase money loans for land and other nondepreciable property could be excepted without endangering tax revenues. In addition, many loans for depreciable property afford little tax abuse potential. Examples of loans with little abuse potential would be loans for amounts constituting only a modest percentage of the basis of depreciable property and loans with respect to depreciable property possessing a recovery period longer than the term of the loan.

ATTACHMENT 1

Part I

Section 1274——Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 467, 483, 7872; 1.483—1.)

Rev. Rul. 85—51

For purposes of section 1274(d) of the Internal Revenue Code, the short-term, mid-term, and long-term applicable federal rates (AFR) for the six-month period, July 1, 1985 through December 31, 1985, are as follows:

		Period for Compounding			
		Annual	Semiannual	Quarterly	Monthly
			Short-Term		
	AFR	10.41%	10.15%	10.02%	9.94%
110%	AFR	11.48%	11.17%	11.02%	10.92%
120%	AFR	12.55%	12.18%	12.00%	11.88%
			Mid-Term		
	AFR	11.78%	11.45%	11.29%	11.19%
110%	AFR	13.00%	12.60%	12.41%	12.28%
120%	AFR	14.21%	13.74%	13.51%	13.36%
			Long-Term		
	AFR	12.07%	11.73%	11.56%	11.45%
110%	AFR	13.32%	12.90%	12.70%	12.57%
120%	AFR	14.58%	14.08%	13.84%	13.68%

SAFE HARBOR INTEREST RATES

The tables below are designed to assist readers in determining this month's safe harbor interest rates that must be incorporated in debt instruments and similar transactions under sections 280G (relating to "golden parachute" arrangements), 467 (relating to deferred payments for the use of property), 468 (relating to mining and solid waste reclamation and closing costs), 483 (relating to interest on certain deferred payments), 1274 (relating to the determination of issue price in the case of certain debt instruments issued for property), and 7872 (relating to certain low-interest and interest-free loan transactions). Generally, an instrument must carry an interest rate of at least 110 percent of the "applicable federal rate," (AFR) or the IRS will impute an interest rate equal to 120 percent of the AFT. (See *Tax Notes*, November 12, 1984, p. 605.)

Safe harbor rates. Table 1 sets forth the AFR for the period January 1, 1985 through June 30, 1985 determined under section 1274(d). Table 2 sets forth the AFR for the month of April computed under the alternate method specified in section 1.1274-6T of the temporary regulations. Table 2 is effective for purposes of applying code sections 467, 483, 1274 and 7872 whenever the rates calculated under the alternate method are *lower* than the six-month rate determined under section 1274(d).

Table 1

JANUARY 1, 1985—JUNE 30, 1985 AFR

	Annual	Semiannual	Quarterly	Monthly
		Short-term[1]		
AFR	12.37%	12.01%	11.83%	11.72%
110% AFR	13.65%	13.21%	13.00%	12.86%
		Mid-term[2]		
AFR	13.37%	12.95%	12.75%	12.61%
110% AFR	14.75%	14.25%	14.00%	13.84%
		Long-term[3]		
AFR	13.43%	13.01%	12.81%	12.67%
110% AFR	14.82%	14.31%	14.06%	13.90%

[1] Not more than three years.
[2] More than three years but not more than nine years.
[3] More than nine years.
Source: *Rev. Rul. 84-163, Tax Notes, Nov. 12, 1984, p. 605*

Table 2

APRIL 1985 AFR

	Annual	Semiannual	Quarterly	Monthly
		Short-term		
AFR	10.37%	10.11%	9.99%	9.90%
110% AFR	11.43%	11.12%	10.97%	10.87%
120% AFR	12.50%	12.13%	11.95%	11.83%
		Mid-term		
AFR	11.84%	11.51%	11.35%	11.24%
110% AFR	13.06%	12.66%	12.47%	12.34%
120% AFR	14.29%	13.81%	13.58%	13.43%
		Long-term		
AFR	12.22%	11.87%	11.70%	11.59%
110% AFR	13.49%	13.06%	12.85%	12.72%
120% AFR	14.75%	14.24%	14.00%	13.84%

Source: *Rev. Rul. 85-40, Tax Notes, April 15, 1985, p. 264*

Special safe harbor. The temporary regulations provide a special safe harbor for section 483 and section 1274 transactions. (See Treas. Reg. sections 1.483-2T and 1.1274-3T). Solely for determining if a contract has unstated interest under section 483 or for determining if a debt instrument issued in exchange for property has adequate stated interest under section 1274, the AFR will be the lowest of:

- The six-month AFR (Table 1);
- The monthly AFR for the month for which the determination is being made (Table 2);
- The monthly AFR for the month preceding the month for which the determination is being made (Table 3);
- The monthly AFR for the second month preceding the month for which the determination is being made (Table 4).

If it is determined that a contract has unstated interest under section 483 or that a debt instrument has inadequate stated interest under section 1274, the rates for the prior two months (Tables 3 and 4) do not apply in determining the amount the IRS will impute.

These tables will be updated as new rates are determined.

Table 3

MARCH 1985 AFR
(Special Safe Harbor)

	Annual	Semiannual	Quarterly	Monthly
		Short-term		
AFR	9.77%	9.54%	9.43%	9.36%
110% AFR	10.77%	10.49%	10.38%	10.27%
120% AFR	11.78%	11.45%	11.29%	11.19%
		Mid-term		
AFR	11.30%	11.00%	10.85%	10.76%
110% AFR	12.47%	12.10%	11.92%	11.81%
120% AFR	13.64%	13.20%	12.99%	12.85%
		Long-term		
AFR	11.72%	11.40%	11.24%	11.14%
110% AFR	12.93%	12.54%	12.35%	12.22%
120% AFR	14.15%	13.68%	13.45%	13.31%

Source: *Rev. Rul. 85-25, Tax Notes, March 18, 1985, p. 1099*

PERIOD FOR COMPOUNDING
MAY 1985 AFR
(Alternate Method)

	Annual	Semiannual	Quarterly	Monthly
		Short-term		
AFR	**10.38%**	10.10%	**9.98%**	**9.89%**
110% AFR	**11.42%**	11.11%	**10.96%**	**10.86%**
120% AFR	**12.49%**	12.12%	**11.94%**	**11.82%**
		Mid-term		
AFR	**11.83%**	11.50%	**11.34%**	**11.23%**
110% AFR	**13.05%**	12.65%	**12.46%**	**12.33%**
120% AFR	**14.28%**	13.80%	**13.57%**	**13.42%**
		Long-term		
AFR	**12.21%**	11.86%	**11.69%**	**11.58%**
110% AFR	**13.48%**	13.05%	**12.84%**	**12.71%**
120% AFR	**14.74%**	14.23%	**13.99%**	**13.83%**

STATEMENT OF SCOTT L. SLESINGER, EXECUTIVE VICE PRESIDENT, NATIONAL APARTMENT ASSOCIATION, WASHINGTON, DC

Mr. **Slesinger**. Thank you. Mr. Chairman, my name is Scott Slesinger. I am executive vice president of the National Apartment Association, a trade association representing over 200,000 owners, developers, managers, and industry suppliers of over 3 million apartment units across the country. I want to limit my remarks to comments that haven't been made by other witnesses. I think some points should be made very clear, and that is that real estate sales especially of apartments are very important to keep our housing stock in a good condition. Rehabilitation usually takes place at sales, because the new owners have the ability to put in new cash to keep the housing stock up. Because of the high interest rates required by the present law, sales are not taking place and buildings are not being rehabbed. One of the transactions that was being contemplated between two of my members was the sale of a $10 million apartment building. The offer was $2 million cash and wrapping a $5.5 million existing loan with a $2.6 million second mortgage. But because the transaction could not be closed by the end of the year to meet the standards that were required, the seller would have to charge 28 percent on his second loan to reach the appropriate rate. and lower the price of the building from $10 million to $8.5 million. The buyer wanted to invest over $300,000 in fixing up that building, but because the deal could not go through, that rehabilitation did not take place. The rents on the building were lowered, averaging around $275 a month. The rental stream would not allow the necessary rehab. I think, as Mr. Wechsler pointed out, we can make narrow rules and do away with the abuses and allow regular transactions to take place. Mr. Pearlman in his testimony mentioned a situation with 100 percent owner-financing, 30 years, and I believe it is 9 percent that caused a 30-percent overstatement of basis. The normal transaction is not like that. The normal transaction is closer to 7 to 12 years in length. It is very rare to see more than 50 or 60 percent of the financing to be owner financing, and with those two changes, the amount of overstatement of basis is very, very minor. We believe the rules could be written to take care of the abusive situation that Mr. Pearlman mentioned and still allow the normal business transactions to take place. A major problem we have is with using the Federal rate. The Federal rate now has gone down considerably, but we have also found that owner financing rates would not have gone down. Owner financing rates are much more stable than the applicable Federal rate. And at this time, we find that it is not a bond. We have suggested using the home loan bank board's cost of fund as a truer index of a wholesale rate. Another problem with the AFR is that it takes in for longer term transactions financing between 9 and 30 years, where most owner financing is closer to the 12-year term. By throwing in that very long term which does not really influence—is not really applicable to real estate, the rate is much higher than it should be. We think that the 80 percent or equivalent rate would allow these transactions to take place. We must remember that the average apartment unit costs about $30,000 a unit. We have exempted $250,000 single family homes. Because of the economy's scale, those large transactions above $3, above $4 million are the only way to build affordable rental housing. We must be sure that when we structure these rules we don't just say big is bad. Thank you very much for the comments of our association. I am ready to answer your questions.

Senator **Chafee**. Thank you very much, gentlemen.

[Mr. Slesinger's prepared statement follows:]

TESTIMONY OF SCOTT L. SLESINGER, NATIONAL APARTMENT ASSOCIATION

My name is Scott Slesinger. I am Executive Vice President of the National Apartment Association * (NAA) on whose behalf I am appearing today.

The NAA represents the interests of the multifamily rental industry. The OID/imputed interest rules affect our industry in several ways. They affect the way property is sold, the extent rehabilitation work takes place, and ultimately the rent levels which we can charge our residents. Our industry is unique because, unlike many others, our clientele consists almost entirely of low-and moderate-income households. In 1983, the median income of these renters was $13,400 and approximately 30 percent of their income was devoted to rent. There are approximately 30 million renter households in America.

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* The National Apartment Association (NAA) is a trade association representing over 200,000 owners, developers, managers and industry suppliers of over three million rental units and condominiums nationwide. The NAA is headquartered at 1101 14th Street, N.W., Suite 804, Washington, D.C. 20005.

In the rental housing industry, increased costs cannot be easily passed on to the ultimate consumer because they cannot afford it. Further, the consumer demand for our product is inelastic. There is no choice to "go without" when it comes to housing. Our goal, and a goal of society, is to provide housing at an affordable price.

The Tax Reform Act of 1984 extended the OID and imputed interest rules to real estate transactions. These rules require parties to a seller financed transaction to lend at certain "safe harbor" interest rates. If the parties fail to meet the safe harbor test of 110 percent of the applicable federal rate (AFR), then for tax purposes an interest rate of 120 percent of the AFR would be imputed. The value of the property would be recalculated as if the imputed rate was the effective interest rate. Interest income would also be imputed to the seller/lender at the imputed rate, even though it exceeds the interest received. This unreceived yet taxable interest income is called "phantom income."

Very few seller/lenders are willing to be taxed on phantom income. Interest rates on seller financed real estate transactions are now higher and there is no deferral of any part of the interest payment. The application of these rules to real estate has had the effect of requiring greater cash flows from the property endangering the economy of the property. Funds that would have been spent on rehabilitation when the property is sold will now go to interest payments.

The OID and imputed interest rules represent a response to perceived abuses of prior law that enabled the parties to overstate the principal element of a transaction and to take advantage of the ability to mismatch the deductions claimed by the purchasers of property and the reporting of income by the seller. In certain cases, low interest rates have been a vehicle to shift ordinary gain to capital gain, and to increase the depreciable basis of the property. However, those cases are overshadowed by the normal operations in commercial real estate where interest rates move far slower and less dramatically than money market rates. We urge Congress to adopt a reasonable set of rules that do not unduly burden seller-financed transactions.

Mr. Chairman, we believe this Committee did succeed in ending the perceived abuses in this area by prohibiting the mismatching of interest expense and interest income by the application of the OID rules to real estate transactions. However, we believe the Congress went too far in requiring unreasonable rates of interest in transactions where the AFR is just not applicable.

Therefore, further restrictions to control the alleged abuses wherein income was shifted from ordinary to capital gains are unneccessary. The Tax Reform Act of 1984 also instituted penalties for the underreporting of tax liability due to overvaluation of property (IRC Section 6659). We believe this penalty as well as other tax shelter reporting requirements will curb abuses that involve the shifting of income that may lead to overvaluation.

The Treasury Department has made recommendations to the Committee concerning the type of seller-financed transaction that tends to be abusive or that causes significant revenue loss. Generally, those types of transactions include long-term loans in excess of 12 years and a very high percentage of seller financing. Cases that involve 100% seller financing and terms of greater than 12 years are rare. But these types of cases are used to highlight the alleged abuses and to calculate part of the revenue loss to the Treasury.

The NAA objects on public policy grounds that any person or any industry should be forced to "pay" for corrective legislation. It is the job of Congress to make laws that promote the best interests of the nation. This is a dangerous precedent to set.

Assuming that some revenue must be generated, the NAA urges the Senate to obtain that revenue from those types of seller-financed transactions that are abusive or that lose revenue. We do not oppose legislation that penalizes abusive tax schemes. We suggest that you place a progressively higher interest test rate on those loans that have terms in excess of 12 years. This would either discourage those transactions or make them structure those transactions at the higher rate. In either case, the revenue impact will be positive.

This type of remedy also has the advantage of placing the burden of paying for seller-financing on those who use it. This is preferable to lengthening the depreciation period from 18 to 19 years and making the entire industry pay.

We share the Congressional concern with abusive tax practices that raid the Treasury and add to the federal deficit. The improper tax impact utilizing purchase money financing results from longer term contracts. Contributing to the negative revenue impact are tax bracket arbitrage, shifting of ordinary income to capital gain as well as inflated asset basis subject to investment tax credit and ACRS. The inter-relationship of the buyer's and seller's tax effects, with shorter term purchase money financing under the recently enacted rules, can be used to reduce overall federal revenues. To avoid this result, an exclusion from the imputation rules should be created for purchase money financing when the term of the loan is less than the ACRS recovery period for the asset that is the subject of the sale transaction. An example of how Treasury loses money is attached to my statement. By exempting the financial transactions of less than 12 years from the OID/imputed interest rules, Treasury could enhance the revenue and cause less disruption to normal real estate transactions.

On May 8, 1985, the House Ways & Means Committee reported legislation that would set the test rates at the lesser of 9 percent or 100 percent of the AFR for amounts below $2 million. For amounts between $2 million and $4 million, the test rate would be an average of the 9 percent and 80 percent of the AFR. For loans over $4 million, the test rate for the entire seller-financed loan would be 100 percent of the AFR. Assumptions would be excluded, but wrap-around loans would not.

The NAA supports the Durenberger Bill, S. 759, because it uses the reasonable test rate of 80 percent of the AFR. It provides some additional relief for smaller transactions. It alo exempts both assumptions and wrap-around loans. The Durenberger Bill uses a moderate rate that allows business to continue, but prohibits the abusive transactions.

The Congress must make a policy decision as to the degree of the government's role in regulating business transactions. Congress must choose between making laws that prevent abuses, or laws that regulate and restructure every transaction to suit a certain model transaction. To establish interest rates and thereby restructure transactions is beyond the proper function of the tax code, particularly when the value of the investment is affected by factors that are not related to the interest rate.

The tax code must be practically administrable and conform to the reasonable expectations of persons engaged in everyday transactions. There are many provisions in the tax code that reflect the understanding that pure tax and economic theory does not always make good tax law. Some of these provisions are: permitting the use of the cash method of accounting, not taxing the imputed income of owner-occupied residences, and non-taxation of certain in-kind fringe benefits. The sale of residential real estate is an area where it is important that the tax law apply in a manner that meets the parties' reasonable business expectations. The innovative nature of business should not be hamstrung and forced to comply with certain models.

Those who advocate very strict OID/imputed interest rules would have Congress believe that every seller-financed transaction is entered into for the purpose of tax avoidance. This point of view fails to understand or address the business relationship between the parties, the nature of the investment and the real estate industry.

Mr. Chairman, the Committee must recognize that seller-financing is an essential tool in our industry. Banks, thrifts, and other lending institutions are not willing to finance every transaction. Many times seller financing is the only way an individual can make the sale. This is especially true for rental housing that needs substantial rehabilitation. Otherwise an owner, who may not have the financial ability to keep up the value of the property, may not be able to sell the property. The problem of liquidity of the asset is aggravated if the seller cannot assist the sale.

The strict application of the OID/imputed interest rules to investments in real estate incorrectly presumes that the value of real estate is determined by interest rates alone. An investment in real estate is not the same as an investment in a fixed rate bond. There is no guaranteed fixed rate of return, nor is there a fixed term. Where the price of a bond will drop as interest rates rise, the value of real estate, especially residential rental real estate, does not automatically move as interest rates move. Real estate values are subject to many forces (rent control, zoning, demographics, liquidity) in addition to interest rate fluctuations.

For example, the value of an apartment building will decline the moment a city institutes rent control because the ability to raise rents and the income stream will be limited. This will happen even if interest rates decline.

Therefore, it is not proper to calculate the value of real estate by using a high interest rate as the single factor. To the extent real estate values are affected by factors other than interest rates, the use of interest rates as a factor in calculating the value should be reduced.

INTEREST RATE LEVEL

The interest rate level which must be charged is the key to the resolution of this issue. The higher the rate, the more exceptions the legislation will have, thereby making it complicated. The attached graphs compare institutional mortgage rates versus their cost of funds. Today, the prime rate is 10.5 percent. The Veterans Administration (VA) rate on a 30-year fixed rate mortgage loan is 12.5 percent. Yet, the mid-term safe harbor rate for May is 13.05 percent calculated under the alternate method, Temporary Treasury Regulation (1.1274 - 6T) and 14.75 percent when calculated under the six month formula in the law. We are suffering under an unfair burden of having higher rates forced upon us. As a general rule, lending institutions must charge mortgage interest rates that are two to three and one-half percentage points above their cost of funds. These rates are charged by lending institutions in order to cover overhead expenses and defaults, provide other services to their customers, and show a profit to their owners and shareholders.

Generally, sellers of property do not have these obligations and are much more familiar with the true value and potential of the collateral than a third party lender. Therefore, they do not have to charge the same high interest rates. A seller who makes a loan to liquidate his investment compares the loan rate with the return he could get with that money, such as the rate on a certificate of deposit (CD). To force seller-financing rates up to institutional lending levels is unrealistic and based on the false presumption that institutional lenders are the only market setters. The interest rate level which sellers must charge must be lowered.

INDEX

Not only should the rate be reasonable and represent an interest level that accommodates the needs of the parties, but it should be pegged to a less volatile index than Treasury securities. The graph on page 20 shows the various T-bill indices over time. They fluctuate with the money markets on a daily basis. The T-bill rates are subject to influences that are not related to the real estate market. T-bill rates are sensitive to domestic and international politics; gold, oil and other commodity prices; worldwide monetary exchange rates, as well as our own stock and bond markets. Due to the volatility of the AFR, we strongly recommend that a cap be adopted that would protect the industry when interest rates spike.

It is at these critical times that seller-financing becomes extremely important because it is the only financing available.

We recognize that the AFR is used in other sections of the tax code. However, it should not dictate that it be used in all cases; especially when there is a better index.

The NAA recommends that Congress consider the Federal Home Loan Bank Cost of Funds Ratio as an index. The Cost of Funds Ratio is the weighted average rate at which thrift institutions borrow. It includes interest which thrifts pay on CDs, savings accounts and their borrowings from the Federal Home Loan Bank. We believe using the Cost of Funds Ratio as an index has several advantages. It is less volatile than the T-bill rates. It also represents the wholesale cost of money to thrift institutions. The Cost of Funds Ratio is made up of interest payments that thrifts pay on savings accounts and CD's to their customers. As stated earlier, sellers will consider the alternate use of the money when negotiating seller financing.

The Cost of Funds Ratio is also real estate related. Thrift institutions play a large role in real estate mortgage lending. Because of these features the Cost of Funds Ratio may be more appropriate as an index.

CALCULATION OF THE AFR

The law provides a formula for calculating the AFR by using an average rate of T-bills over a period of time. However, we have found that by using this formula, the AFR does not represent true market conditions. It takes the average T-bill rate from April to September of 1984 to arrive at the AFR for January through June of 1985. In other words, the safe harbor rate incorporates factors that are 3 to 15 months late. As rates dropped in 1985, the safe harbor rate (based on lagging higher rates) was higher than bank rates. In response, Treasury issued rules that created a monthly AFR which had only a one-month lag time.

The ability to elect the lowest safe harbor rate has a beneficial effect and we seek to preserve the election. By being able to select a current rate or a lagging rate, we will be able to avoid the spikes in interest rates. As rates go down the monthly rate would be more favorable. As rates increase, the ability to use a rate that was calculated during a more reasonable interest rate climate would be more favorable. The ability to avoid some of the fluctuations of the market is essential.

Mr. Chairman, whether the rate level is calculated using T-bills or the Cost of Funds Ratio, the Committee must provide some leeway in setting the rate in order to allow parties to customize transactions that will accommodate their needs and circumstances. Congress should not be in the business of setting interest rates for private transactions. Congress' goal should be to set a reasonable minimum rate that prevents abuses of the tax code. We believe that a rate that approximates the CD rate which is about 80 percent of the AFR is a reasonable level.

ASSUMPTIONS AND WRAP-AROUND FINANCING

The Tax Reform Act of 1984, which was followed by stopgap legislation (P.L. 98-612), left some confusion as to the status of transactions that involve assumptions, wrap-around financing, and the taking of property subject to a loan. The confusion centers around whether the amount of the pre-existing financing should be aggregated with the new seller financing to reach the $2 million threshold when wrap-around financing is used. A wrap-around loan is the incorporation of pre-existing debt into a single larger loan with some new financing.

It is NAA's position that the rules should apply only to the new seller-financing portion of a wrap-around loan. Pre-existing financing and loans from third parties should not be subject to the OID or imputed interest rules, as long as that loan was in compliance when it was originally made. We also believe that such prior loans, or third party loans should not be included in reaching the threshold level.

The fact that a property has financing that is assumable is an asset that is an inseparable part of that property. The purchaser who commits to a long-term interest rate pays for that rate as well as the assumability feature. To penalize that owner for obtaining financing that was at the market rate at the time it was incurred is not proper. The new seller financing should be the only amount subject to the new rules.

In defining what an assumed loan is, Congress should recognize that lenders will normally impose additional restrictions on the new borrower(s) when a loan is assumed. The restrictions might include a shortening of the term of a balloon loan, requiring the payment of additional points upon a subsequent assumption, the prohibition of subsequent assumptions, or the pledging of additional security. The essential terms of the loan remain unchanged. The alterations are usually to the borrower's disadvantage and do not have significant tax consequences. A strict requirement that the terms of an assumed loan remain completely unchanged is not realistic. The NAA urges that a substantial economic or substantial tax impact test be applied.

THRESHOLD AMOUNT

Current law provides a $2 million threshold level to distinguish between small and large sized transactions. A rough average per unit purchase price of a multifamily building is $30,000. The $2 million threshold would apply to a property with only 66 apartment units. The NAA favors a higher threshold amount to protect the small and medium sized transactions from the full impact of the legislation.

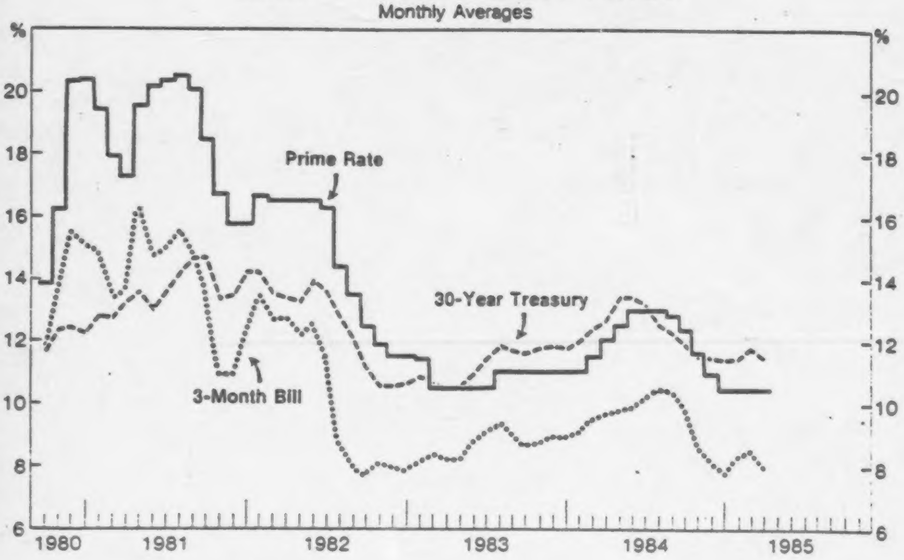
The law exempts single-family homes with sale prices of up to $250,000. At the same time it applies to multifamily apartment buildings where the units may be worth only $30,000 apiece. The fact that a multifamily project is providing housing for 66 families under very modest circumstances is ignored.

Again, I emphasize that the goal of good tax laws should be to let business go about its business while preventing abuses of the system. The law must recognize the business realities that exist.

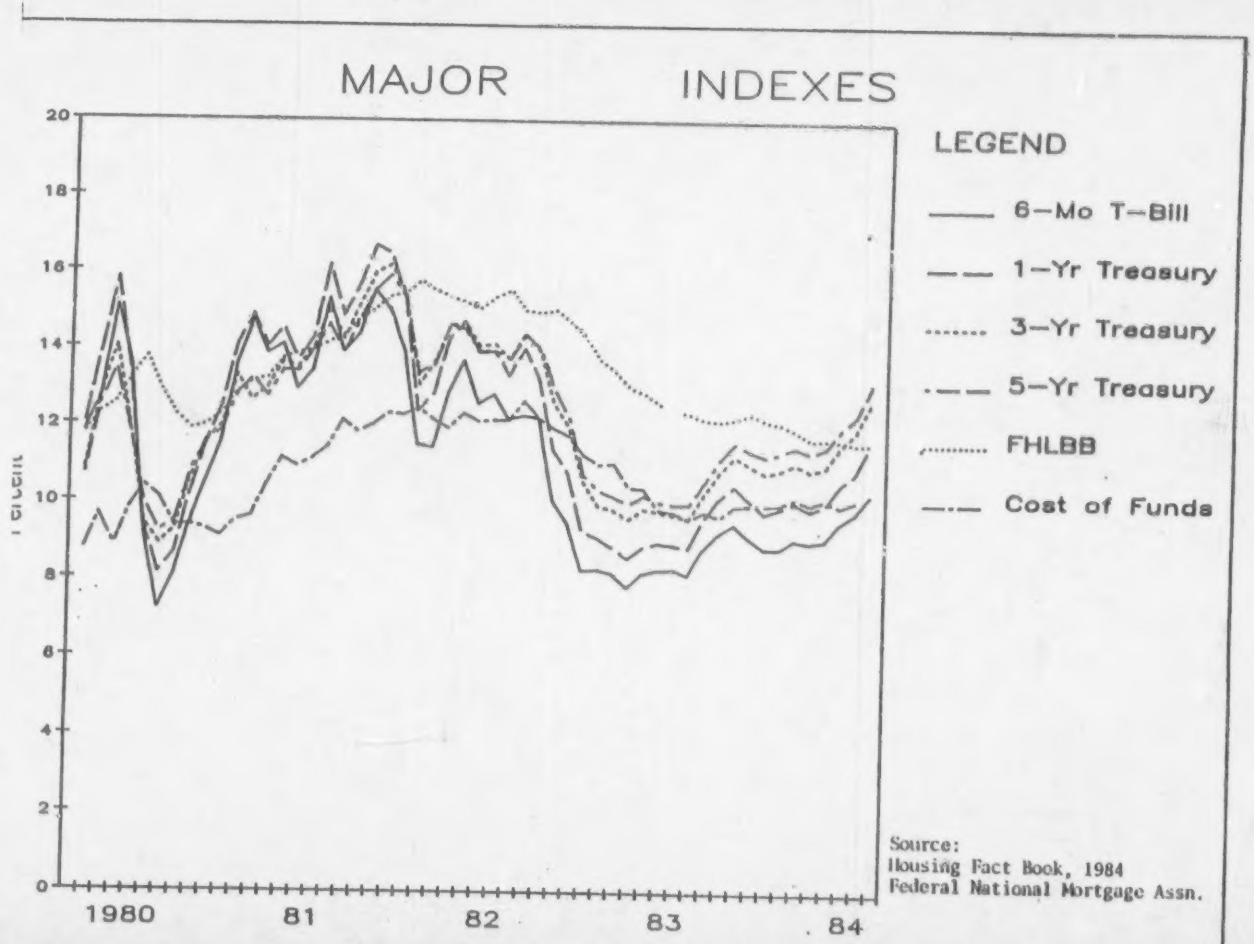
The NAA urges Congress to play a less intrusive role in setting interest rates. A reasonable rate would prevent abuses, but not dictate the terms of a contract. Investments in real estate are not investments in fixed interest rate instruments. Due to all of the variables involved in real estate, Congress cannot pour all transactions into one mold. The NAA believes that a rate of 80 percent of the AFR is a reasonable level. Thank you for hearing our views. I would be glad to answer any questions you may have.

SHORT TERM INTEREST RATES

Monthly Averages



April 30, [illegible]



Source:
Housing Fact Book, 1984
Federal National Mortgage Assn.

1984 TAX REFORM ACT

Imputed Interest Example

Assume a purchase money note has seven years at 9% interest only paid currently with annual payment in arrears on $1 million. Further assume the applicable federal rate is 10% so that the 1984 Tax Act requires imputation at 12%. The imputed value of the purchase money note is $863,087, requiring the seller to recognize $136,913 interest income during the term of the note without cash to meet tax obligations and then reducing the deferred capital gain recognition upon principal payment. The buyer would recognize $136,913 additional interest deduction while depreciation expense would be reduced $7,606 per year on a straight line basis using 18 year ACRS for the number of years of ownership.

Over the seven year period, the seller experiences $82,148 more ordinary income, net of the reduced capital gain, which has a present value at 12% of $60,039. The buyer experiences $83,671 of additional ordinary deductions, net of the reduced depreciation expense, and this additional deduction will gradually approach zero if the buyer holds the property for 18 years. If the buyer holds the property for 18 years, the present value of added deduction is $29,671 (i.e., a net tax benefit). Over the seven years, the present value, at 12% of the buyer's added deduction, is $50,100. Therefore, with a seven year hold, the Treasury benefits by $9,939 net revenue recognition in present value terms. If the 175% declining balance is used, the Treasury benefit is $28,959.

If buyer and seller are in the same tax bracket and subject to the same rate of state taxation, the buyer must hold the property for more than 5.5 years using straight line ACRS, or more than 2 years with 175% ACRS, while paying the seller off at time of sale for tax revenues to be unchanged as a result of the 1984 Tax Reform Act. If buyer sells earlier or sells without retiring the original purchase money financing, the government will experience a net tax reduction.

If the buyer is in a 50% tax bracket and the seller a 30% tax bracket, (a more likely scenario), the buyer must hold the property for nearly eleven years for the present value of tax revenues to be positive, if straight line ACRS is used. If 175% ACRS is used, the holding period must be eight years. With typical holding periods of seven years, the present value of lost tax revenues (of seller's @ 30% and buyer's at 50%) is approximately $7,000 for every $1 million of purchase money financing, whether straight line or 175% ACRS is used. For every $10 billion of purchase money financing for real estate transactions, the federal government deficit is increased by $70 million.

EXAMPLE OF IMPUTED
PURCHASE MONEY NOTE
INTEREST RECOGNITION

Year	Beginning Imputed Principal	Imputed Interest @ 12%	Interest Paid	Interest Differential
1	$ 863,087	$103,570	$ 90,000	$ 13,570
2	876,657	105,199	90,000	15,199
3	891,856	107,023	90,000	17,023
4	908,879	109,065	90,000	19,065
5	927,944	111,353	90,000	21,353
6	949,297	113,916	90,000	23,916
7	973,213	116,787	90,000	26,787
Final Principal	$1,000,000			
TOTALS		$766,913	$630,000	$136,913

ASSUMPTIONS:

A $1 million purchase money note requiring interest only payment of 9% per year paid annually with principal due in seven years. At the time of creation of the purchase money note, the applicable federal rate is 10% so that the 1984 Tax Reform Act requires imputation at 12%.

TAXABLE INCOME RECOGNITION CHANGES
FROM INTEREST IMPUTATION

Assume Buyer and Seller must report income/expense on a cash basis rather than the accrual basis currently required by statute.

Seller: a) Additional interest income recognition
 b) 40% of the reduction in the capital gain recognition

Buyer: a) Additional interest expense recognition
 b) Reduced ACRS deduction 1.75%

Year	Seller		Buyer		Net Change
	(a)	(b)	(a)	(b)	
1				13,311	13,311
2				12,724	12,724
3				12,127	12,127
4				11,521	11,521
5				10,904	10,904
6				10,275	10,275
7	136,913	(54,765)	(136,913)	9,632	(45,133)
8				8,976	8,976
9				8,303	8,303
10				7,611	7,611
11				6,897	6,897
12				6,158	6,158
13				5,388	5,388
14				4,580	4,580
15				3,721	3,721
16				2,791	2,791
17				1,745	1,745
18				249	249

TAXABLE INCOME RECOGNITION CHANGES
FROM INTEREST IMPUTATION

ACCRUAL BASIS

Seller: a) Additional interest income recognition
b) 40% of the reduction in the capital gain recognition

Buyer: a) Additional interest expense recognition
b) Reduced ACRS deduction -1.75%

Year	Seller		Buyer		Net Change
	(a)	(b)	(a)	(b)	
1	13,570		(13,570)	13,311	13,311
2	15,199		(15,199)	12,724	12,724
3	17,023		(17,023)	12,127	12,127
4	19,065		(19,065)	11,521	11,521
5	21,353		(21,353)	10,904	10,904
6	23,916		(23,916)	10,275	10,275
7	26,787	(54,765)	(26,787)	9,632	(45,133)

TAXABLE INCOME RECOGNITION CHANGES

Seller: a) Additional interest income
b) 40% of reduction to capital gain

Buyer: a) Additional interest expense
b) Reduced ACRS deduction - Straight line

Year	Seller		Buyer		Net Change
	(a)	(b)	(a)	(b)	
1	13,570		(13,570)	7,606	7,606
2	15,199		(15,199)	7,606	7,606
3	17,023		(17,023)	7,606	7,606
4	19,065		(19,065)	7,606	7,606
5	21,353		(21,353)	7,606	7,606
6	23,916		(23,916)	7,606	7,606
7	26,787	(54,765)	(26,787)	7,606	(54,765)

Senator Chafee. Let's just discuss what the imputed interest rate should be now, for a few minutes. I would like to draw you all into this. I just have great trouble understanding your suggestion that the imputed rate should be 80 percent of the applicable Federal rate. Is that correct? Isn't that what you are saying, Mr. Slesinger?

Mr. Slesinger. I think, depending on what index it is, presently we think that 80 percent would be a fair number. Our people tell us that owner financing would work.

Senator Chafee. I would like to get specific answers from each person. We do have some other witnesses coming on. You know, none of you, or the people you represent, none of them, could go out and borrow at 80 percent of the Federal rate. There is no way in the world to do that, and I just don't understand why you consider it so normal to have the imputed interest be at this uncommonly low figure. Frankly, I don't think you can borrow at the Federal rates never mind 80 percent of it.

Mr. Wallace. Mr. Chairman, as a matter of fact, history shows us that that is exactly what happens. The seller is really basically interested in disposing of his property, and he may do all kinds of things—lower the price, cleanup the property, and offer a submarket rate in all——

Senator Chafee. You were talking about the unsophisticated sellers who would be hurt in your testimony. I think you used those words.

Mr. Wallace. That is true.

Senator Chafee. Look, we are dealing with $2 million sales here. We are not dealing with somebody who is selling his house.

Mr. Wallace. You raised that earlier, Mr. Chairman. and I have got to tell you that—I heard your comments about Rhode Island and I have met with your Rhode Island realtors, and we chatted with you a month ago when we were here—but I can tell you, coming from where I came from this morning, 3,000 miles away in California—in Hawaii, and Texas and in Illinois and in various places throughout the country—small transactions not only involving homes but small business transactions, the mom-and-pop apartment houses, the small commercial properties are easily up to $3 and $4 million, and they are not dealing with a barrage of accountants and attorneys when they effect these transactions. So, I can tell you that we feel, unless you want to revisit this issue every few years, that the types of thresholds we have suggested are really appropriate.

Senator Chafee. Let me get back to the 80 percent. What you would use as the imputed interest rate? Do you suggest 80 percent?

Mr. Wallace. Yes. Absolutely.

Senator Chafee. Mr. Smith?

Mr. Smith. We said no higher than the Federal rate.

Senator Chafee. You mean that it used to be?

Mr. Smith. Yes.

Senator Chafee. Mr. Wechsler.

Mr. Wechsler. We recommend 80 percent of the AFR and, in addition, if the chairman or the committee would feel that is overly generous or unrealistic, we have stated readily many times that there is a large class of transactions which, even at 80 percent of the AFR, has a nominal overstatement of basis and therefore increased depreciation or none at all and a nominal overstatement of capital gain. We would recommend that, because of times in high interest rates when sales would be shut down otherwise, that this should be permitted.

Senator **CHAFEE**. Do you gentlemen think that computing the threshold, we should look at the debt financing or to the total sales price?

Mr. **WALLACE**. Absolutely to the debt. To do it otherwise is—and I listened to Treasury's testimony—and to do it on sale price is going to be hopelessly confusing. What you really want to do is tie it to the debt and that is a very clear cut measurable factor against whatever thresholds you permit. So, I think you will avoid a lot of complexity if you tie it to debt and not sale price.

Senator **CHAFEE**. Mr. Smith.

Mr. **SMITH**. Debt.

Senator **CHAFEE**. Mr. Wechsler?

Mr. **WECHSLER**. We would concur it should be debt because in fact, as you I think had pointed out earlier, there really is no difference if it is depreciable property, particularly between a $1 million transaction and a $100 million transaction. In fact, $1 million of seller financing on a $100 million transaction will have a lot less impact than a $1 million seller financing on a $1 million transaction.

Mr. **SLESINGER**. We agree that it makes a lot more sense to put it on the amount of financing.

Senator **CHAFEE**. Are all of you supporting the House bill?

Mr. **WALLACE**. Yes.

Senator **CHAFEE**. Are you all happy with the House bill?

Mr. **WALLACE**. Well, not totally.

Senator **CHAFEE**. All right.

Mr. **WECHSLER**. We think it was a substantial step ahead in this matter and what it did on assumptions and the 100 percent test rate, we view very favorably.

Senator **CHAFEE**. In any event, what the House has done is extended, the depreciable life of real property from 18 to 19 years. It seems to me a little unfair that the depreciable life should be extended that far just to take care of or to make up revenue for seller financed transactions. How about the fellow who doesn't have a seller financed transaction? He is affected—the buyer, for example, is affected by this extended period. Is that fair?

Mr. **WALLACE**. No, and in fact, I think with all due respect Treasury and Congress made a mistake last year, and it wasn't for revenue-raising purposes. I think they hurt seller financing in the worst possible time, and I think the mistake ought to be rectified without a revenue prop. However, this is so critical to our industry in harsh times that I would tell you if it has to be, that is probably an area—raising the depreciable useful life by a year—where you can offset with that amount of revenue and have it semirelated to the resolution of the problem.

Senator **CHAFEE**. What are you saying? It should have stayed at 15?

Mr. **WALLACE**. No, I am saying at 18—it is 18—and I don't think we ought to change it, but if it has to be, this issue is so important that I think our association is willing to step aside and let it go to 19.

Senator CHAFEE. Mr. Smith.

Mr. SMITH. We feel the same way. We certainly would have liked to see it stay at 18, but——

Senator CHAFEE. But how about the fellow who doesn't get seller financing? He is affected, too.

Mr. SMITH. That is true.

Senator CHAFEE. Jack Kennedy said the world isn't always fair.

Mr. SMITH. That is right.

Mr. WALLACE. That is right.

Senator CHAFEE. I see. Mr. Wechsler.

Mr. WECHSLER. We are reluctant to go to 19.

Senator CHAFEE. Mr. Smith, did you have something else?

Mr. SMITH. No, as I said, we would have preferred 18, but we felt just the same way that Mr. Wallace testified, that if it had to be, we would rather see it pushed up one year if that is the way it has to be to pay for it.

Senator CHAFEE. Mr. Wechsler.

Mr. WECHSLER. We generally don't believe it is fair to affect all purchasers of real property because of seller financing. And in fact, let me point out something. It is hard to believe that, as you have indicated, that degree of seller financing is out there, particularly on commercial property. Something like over 80 percent of the value of all nonresidential real estate in this country is equity, is not encumbered by debt although most new transactions clearly are heavily debt financed. But as an organization which supported 20 years in 1981 and not 15 years, we are not quite one to complain about going from 18 to 19. It is just not fair in this instance.

Senator CHAFEE. Mr. Slesinger.

Mr. SLESINGER. I think that we ought to try to be as fair as possible, and that maybe as we look at the rules, we should try to make the seller financing pay for itself. I think that if we somehow crafted a rule that would really go after the abuses, there might be some revenue gain on that end of the deal so that—you are right—those people who don't do seller financing wouldn't be paying for seller financing. It will not add to simplification of the Code, but I think you would run into a little more fairness of not charging nonseller financed transactions for seller financing.

Senator CHAFEE. Senator Symms.

Senator SYMMS. Thank you very much, gentlemen, for being here. In the Durenberger-Symms bill, we have set interest rates, so that transactions up to $4 million will use either 9 percent or 80 percent of the applicable Federal rate, whichever is lower. In the event the test interest rate is not met, the imputed interest rate shall be 10 percent or 100 percent of the applicable Federal rate, whichever is lower. Now, is that what you all agree with?

Mr. WALLACE. Yes.

Mr. SMITH. Yes.

Mr. SLESINGER. Excuse me. I think that we all do agree that the House did make one improvement and that is not to have a penalty rate at all, that if you don't reach the statutory rate, you will be charged the statutory rate, not a penalty because of probable unsophistication in the transaction.

Senator **Symms**. So you would recommend that we get the penalty clause out of this bill?

Mr. **Slesinger**. Yes, as the House did.

Senator **Symms**. I wouldn't have any problem with doing that myself. Next, the point is to you, Mr. Slesinger, how is rent going to be affected under current law and how would rent be affected under the approach Senator Durenberger and I have taken?

Mr. **Slesinger**. It would be nice and easy to say yes, rents are going to go up because of this. Rents are a factor of so many different things, such as the present supply, what the people can afford. On commercial real estate, we have a difficulty of passing on higher costs to our residents because they have no one to pass it onto. And if they could afford higher costs, they would probably become home owners. So, we are limited on what we can charge, so it is hard to say what any specific provision would do to increase rents, but obviously, we would see more that there would be less rehabs and that the buildings would not be put up as much if more money in the transaction has to go for interest and not to do things like rehabilitation.

Senator **Symms**. Does anybody else want to comment on that?

Mr. **Wallace**. I think the main thrust is it is just a deal killer. When the 1984 rules are applied—You see when we need seller financing is when the institutions pull out of the market, as they did in the early 1980s, and this is our financing of last resort. So, really, you are taking that vehicle away from us.

Senator **Symms**. One of the reasons this is so important to get corrected then would not only be if interest rates go back up, but let's say, for example, this budget package that is now pending before the Congress falls apart. Is it your opinion then that interest rates will be driven back upward again?

Mr. **Wallace**. I think they are just hovering there waiting. The good news is it looks like something might go together, and you have seen the effects of the market already, including us in the real estate market. But if something isn't resolved there sooner or later, seller financing, I predict, in the next year or year and a half is going to be absolutely imperative at competitive, subinstitutional rates, or we won't survive. We had trouble in 1982.

Senator **Symms**. Senator Chafee asked a question that you commented on earlier about people borrowing money. Now, I met a businessman who is a friend of mine who tells me that he in his business arrangement—I don't know what the details of it are—but he very customarily borrows money from his banks at below the prime rate. Is that an unusual situation?

Mr. **Wallace**. Yes.

Senator **Symms**. You think it is unusual that he could do that?

Mr. **Smith**. I would certainly thihk so. Most of our small builders can't do that. I can tell you that right now.

Senator **Symms**. Well, maybe he has to deposit more money in a cash account or something like that.

Mr. **Wallace**. He is probably borrowing his own money back.

Senator **Symms**. Oh, I see.

Mr. **Wallace**. He is putting up offsetting, compensating balances.

Senator **Symms**. I mean, I have never been able to do it.

Mr. WALLACE. You belong to the majority by far.

Senator SYMMS. But the point is that it does occasionally happen where there are preferred customers who can go to banks and get money at a lower interest rate than some of the rest of us can.

Mr. WALLACE. Yes; but that is unique, if it is less than prime, as in your example.

Mr. SMITH. He probably has accounts offsetting that somewhere with a compensating balance.

Senator SYMMS. The bank is doing it, and they are obviously trying to make a little bit on every account they have, and somehow they figure his is worth it.

Mr. WALLACE. But you see, Senator, I would suggest that the average seller—certainly the average, or probably 98 percent of the home sellers out there—don't give a hoot about what Treasury is saying. They aren't thinking tax related issues.

Senator CHAFEE. But they are not affected by this bill.

Mr. WALLACE. Yes; they are. In the 1984 rules, Senator, they are, and that is why we are here to tell you we need to change it.

Senator CHAFEE. They are exempted by the——

Mr. WALLACE. They aren't in the 1984—they are by very miniscule limits in the 1984 provision, and we are here to tell you that you need to. What Treasury was trying to do is laudible. Get at some of the tax-related issues that led to evasion or nonpayment, the mismatch, and those things. What they did was—and what we allowed to happen last year—to blanket in everybody under a horrible blanket, and we are trying to get them what they want accomplished and yet still let some poor devil out there who wants to sell a home and has to move across the country from Rhode Island to California still survive. You need to change those limits. That is the real guts of the issue. And I think you are close to doing it in your bill, Senator.

Senator SYMMS. I hope we can do it. You know, even though I support my own bill, I would be very happy to leave the law just the way it was until we see what is going to happen after tax reform. I don't understand what all the hubbub is about. You know, these same people who say they are for supply side economics, if they believe it, why not leave the money in the private sector?

Mr. WALLACE. I think you are right. It has worked pretty well for 20 years, and we would love it——

Senator SYMMS. Every day we read in the paper how the Government has wasted more money. Mr. Chairman, thank you.

Senator CHAFEE. Thank you. Gentlemen, I am just a little at a loss here, and obviously you are the gentlemen who can help me out. First of all, there is a $2 million limit, and indeed, the way you would have it, this limit would be on debt, not a $2 million limit on the sales price. I don't know how any poor devil is going to be affected by that who wants to move from California to Rhode Island or vice versa. If he has got a house with $2 million in debt alone, he has the most expensive house in the State of Rhode Island. or darned near. I just think we have to set this aside. I might say, Mr. Wallace, you have got our realtors at home all riled up—the professional ones—and the others don't even know what imputed interest means.

Mr. **Wallace**. I am glad of that.

Senator **Chafee**. The head of the professional ones is after us about imputed interest and brings along some realtors. They are terribly nice, and they go along with him. Then they tell me later they don't know what the thing is all about. So, I just think you have got to set aside the fellow who is going to move from one part of the country to the other. If he is selling a house with $2 million in debt on it, if he hasn't got an accountant or a lawyer in there telling him what to do, I am dumbfounded. What is your answer to that?

Mr. **Wallace**. Senator, I don't think there probably are that many homes, even in California where I am building some, that are going to be that much affected by the $2 million debt limitation, but there are—all of us are dealing with some small investment property owners and apartment house owners, as I indicated, and farm debt. To get you up to $1 million any more in the Farm Belt is not that big a deal, and I predict that if you don't set these sorts of limits, that we are going to be right back at you here in another 24 or 36 months and saying do it over again. So, I think what we are trying to do is exempt those property sales in effect that are really not done by sophisticated people trying to evade taxes, but are just trying to effect a real estate transaction in harsh times when no other moneys are available.

Senator **Chafee**. This question is really directed to Mr. Wechsler. What are we going to do about these sophisticated people who truly do enter their negotiations to minimize their taxes—evade taxes, if you want to call it that. Now, clearly, it can be done. You have seen it. You know. Your people aren't dumbbells out there. I noticed you have a pretty distinguished list of board of directors here. If Mr. Trump doesn't know the Internal Revenue Code a a lot better than I do, I would be surprised. So, they know the difference between capital gains and ordinary income, and without suggesting any of the member of your board are involved in this, clearly people set up deals with a lower interest rate and a higher purchase price so that everything works to their advantage. It gives them less ordinary income. It gives the purchaser greater depreciation. It is great. Now, what are we going to do about it?

Mr. **Wechsler**. I don't deny that sophisticated people will devise ways to minimize taxes. However, they will continue to do it under the 1984 act as passed, whether these changes are made or not. And one of the reasons—and I think it was addressed by Senator Wallop earlier and some others—is that in the Tax Code we have today, you have tremendous disparities in tax rates that people pay. And these rules from 1984 took note of that effect when, on one hand, they say that setting a minimum interest rate or test rate will give you the maximum value of the property, but then there is a big caveat in the law that says, wait a minute, if you are a certain type of transaction, you are potentially abusive, and even the interest rate test isn't good enough.

And one reason that had to be put in there was because people might tend to overstate—be happy to overstate—interest because in the shorter term maturity—and that is, I believe, one of the reasons Treasury has not come around on this antiabuse notion on assumptions—is that it is very difficult to tell sometimes from a buyer's perspective whether they are going to be better off with a higher interest rate or lower interest rate. It depends on the relative tax position of the buyer and seller. So, nothing is as clearcut as I think has been made out to be, and although the theory behind this can become very seductive, given the broader tax picture of all the taxpayers in this country, there is more to it than just this.

Senator CHAFEE. I am not sure you gave me a solution.

Mr. WECHSLER. The solution that we have recommended—and I think some others are considering—is target transactions in which it is very difficult to overstate principal, and those transactions clearly are where you have relatively short-term maturity—say under 12 years—which the bulk of third party and seller financing is anyway. Target those transactions where most of the interest is paid currently, and that is most of the transactions, and you have a much more limited problem. Give them a little better interest rate so you can facilitate transactions, and you admit that you can't scientifically measure value—appraisers have a very difficult time measuring value—I mean, there are variations of 10 or more percent in a given case. I think all the industry is asking is loosen this noose a little bit in those situations where there is very little chance of abuse.

Senator CHAFEE. Let me ask you this, gentlemen. You are talking about the noose and all that, and Mr. Wallace and others have indicated the detrimental effects of this legislation. However, I suspect, and you will have to correct me, that despite this legislation, times are pretty good for you folks. Is that right or wrong?

Mr. WALLACE. Yes; and we don't need that much seller financing today, but we know 1982 will come again. And I think Senator Symms asked me: What happens if the deficit-reduction package falls apart? I say again that we know we are going to have harsh times when the institutional lenders are going to pull out and we will only have the sellers' equities to deal with. And I think we ought to prepare for that time.

Senator CHAFEE. Let me ask you a question in connection with that. Do you gentlemen believe that the value of real estate fluctuates in accordance with interest rates?

Mr. WALLACE. The three most important rules of real estate are interest rates, interest rates, interest rates. Then location, location, location.

Senator CHAFEE. In other words, if you have a piece of land that is worth $1 million when interest rates are 5 percent, you might not be able to get $1 million for it when interest rates are 14 percent. Is that true?

Mr. WALLACE. It depends on the circumstances, but it could well be.

Senator CHAFEE. OK. Thank you all very much for coming, gentlemen. We appreciate it.

Mr. WALLACE. Thank you.

Mr. SMITH. Thank you.

Senator CHAFEE. Now, the next panel is Mr. Schneier, issue coordinator for taxes, National Federation of Independent Business; Mr. Feldewert, Mr. Szymanski, and Mr. Driesler. Mr. Schneier.

STATEMENT OF ABRAHAM SCHNEIER, ISSUE COORDINATOR FOR TAXES, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, DC

Mr. SCHNEIER. Thank you, Mr. Chairman. On behalf of the more than half-million members of the National Federation of Independent Business, I am happy to appear this morning to discuss this issue of imputed interest, which is of importance to small businesses. Briefly, I will summarize my statement, and let me say I have been personally gratified to hear Secretary Pearlman talk about the concerns of small business in this situation. Certainly, for a smaller transaction, simplicity of the tax rules is a major concern for small businesses. Comments have been made as to what level of sophistication there is among small businesses or among businesses in general. We did a survey several years ago on an issue equally as complex—accounting methods and inventory methods—and we tried to determine what level of sophistication there was out there. We discovered that about 20–25 percent of our members were not even using accountants or CPA's or attorneys. They were using, in some cases, public accountants and, in some cases, just bookkeepers. So, there is a tremendous gap in the level of knowledge, and I would have to say that certainly the original issue discount rules and the imputed interest rules probably are among the more complex that are going to impact on small businesses in those limited situations where it does become a concern.

The limited availability of small businesses to go to a financial institution—a third party—and avail themselves of funds also puts small businesses typically in a situation of having to seller finance. The very usual situation is that there is a tremendous amount of good will involved in a small business situation—intangible assets, banks will have a lot of trouble lending money on. They do just not want to become parties to those types of transactions so the buyer and seller will agree among themselves to arrange the financing. And within that concern is the concern of not only the buyer for being able to survive, but the concern of the seller that the buyer survives. Otherwise, his notes turn out to be nothing more than useless paper over a period of years. So, there is this desire to match the need of the buyer and seller, which is just the normal needs of those particular parties. We are pleased to see that the House Ways and Means Committee has gone along with a situation of a $2 million safe harbor at a 9-percent rate, which was the rule under old law, and we would certainly be happy to see the Senate take a similar approach to that particular issue. As far as the other issues which are being reviewed within the legislation—within the proposals rather—there is one concern—partial sales of a business interest—which is a concern to small business because in many situations you have two or three partners and maybe four or five partners in a small business situation. One partner desires to be able to get out of the transaction, and there is a concern that this particular situation not become abusive, that one party not be able to sell five $2 million parcels, but there is also the need of one party out of a five-party transaction being able to utilize the imputed interest safe harbors as well. And we hope that that issue will be—that is an issue for small business. And again, let me summarize by saying we are happy that the small business concerns are being addressed and hopefully will be so in the final solution. Thank you.

Senator CHAFEE. Basically, you like the House bill. Is that right?

Mr. SCHNEIER. For the most part, yes.

Senator CHAFEE. All right. Mr. Feldewert.

[Mr. Schneier's prepared statement follows:]

TESTIMONY OF

Abraham Schneier

Issue Coordinator, Taxes

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before:	Senate Finance Committee Subcommittee on Taxation and Debt Management
Subject:	Tax Treatment of Seller-Financed Sales of Business Property--Imputed Interest
Date:	May 20, 1985

On behalf of the more than half million members of the National Federation of Independent Business(NFIB), we appreciate the opportunity to present the membership's views on the issue of the imputed interest rules enacted in the 1984 Tax Reform Act.

We commend Chairman Packwood for scheduling these hearings to explore the concerns over the imputed interest rules passed in the last Congress. The June 30 deadline is fast approaching, and we are hopeful that with the leadership of Mr. Packwood, Mr. Long, and the other members of the Senate Finance Committee, a solution to this issue can be found that will continue to allow uncomplicated sales of small businesses.

The 1984 Tax Reform Act

The new imputed interest rule established a test rate to be used in determining whether a transaction that is seller financed is abusive, thereby requiring the imputation of income to the seller. The imputed interest rule which existed under prior law in section 483 of the Internal Revenue Code(IRC) held that if a buyer and a seller were utilizing an interest rate below 9% on deferred payments, income would have to be imputed. Treasury and the tax writing committees were concerned that transactions carrying a rate below 9% were disguising an overvalued basis of the property. The effect of overvaluation is to recharacterize ordinary income, which has a maximum tax rate of 50%, into a capital gain, which has a maximum tax rate of 20%. In addition the overvalued basis of the property in the hands of the buyer results in overvalued depreciation benefits.

In place of the 9% test rate, Congress substituted a test rate which specified that a seller must charge a buyer a rate of interest equivalent to at least 110% of the interest rate on government obligations of comparable maturity. If the rate was below this level, a penalty rate of 120% would be imputed in the transaction to all parties.

The passage of the imputed interest rule affected the sales of different types of property which were traditionally seller-financed and resulted in the eruption of a major controversy in Congress. The types of transactions which in the past had been seller financed included sales of personal real estate, sales of farms, sales of businesses, and sales of business property. The impact of the new test rate would be the liquidation, rather than sale, of many small businesses--a result hardly in the best interest of Congress and the general economy.

This test rate would virtually destroy the traditional ability of two private individuals to engage in seller financing as an alternative to the stringent requirements and high rates charged by third parties, such as banks. In addition the rate would prevent the use of seller financing as an alternative financing tool when bank financing is not available.

Small business has always faced a shortage of available capital for financing new and expanding small firms; financing the sale of a small business presents similar obstacles. Long-term financing is generally unavailable to both new businesses and buyers of small businesses unless the buyer is in a position to offer a substantial amount of personal guarantees. Goodwill is often a major asset of a small business, and a bank will not lend money when such an intangible asset is the primary collateral.

To the small business owner who wishes to retire, the available market for his business is usually severly limited because of the inherent risks of buying a small business. Seller financing is often an integral part of the package necessary to make a sale.

The seller often agrees to accept a below-market rate of interest on deferred payments because paying market rates may be unrealistic for the buyer, who must pay off the obligations to the seller and have enough left over to finance expansion and growth. The seller recognizes this problem and is willing to accept the lower rate--and the financial loss--it presents to him.

Safe Harbor Rate

At the end of the 98th Congress, stopgap legislation was enacted that returned transactions under two million dollars to the old imputed rate of 9%. NFIB strongly encourages this Committee to make the exclusion permanent and to make the test rate of 9% permanent as well. While it is realistic to provide the Congress and the IRS conditions under which the 9% rate could be adjusted upward--as IRS has always been able to do--I submit that if interest rates did take off to the 20% level again, imputation of income would be the least of our problems. In fact, in that atmosphere Congress could be forced to encourage below-market seller financing as a realistic way to keep the economy moving.

A 9% limit for small transactions of under $2 million dollars in sales price should be continued as part of any permanent solution. Treasury's proposal that the safe harbor be either $2 million in purchase price or $1 million in financing would be too complicated and should be rejected.

Allowance should be made for adjustment of the 9% rate if conditions warrant, but only under specified circumstances and only with the concurrence of Congress.

Partial Sales of a Business Interest

The safe harbor rates provided should also be available to partial sales of a small business. When a partner or shareholder in a small business wishes to sell his share of a business outright or over a period of time, the special rule for small transactions should apply. This point is critical, since partners in small businesses often break off for various reasons and need the ability to sell their share of the business in seller-financed transactions.

Assumptions

The treatment of loan assumptions should be left as they were prior to the 1984 TRA. The assumption rule was not an issue in the 1984 TRA and should not be a consideration here.

Blended Rates

The issue of blended rates is a minor concern for small business. In any solution of this issue, complexity should be viewed as an undesirable result and, to the extent possible, avoided.

Accounting Methods

The accounting methods provided by the OID rules require that the accrual method of accounting be used by the buyer and the seller in any transaction involving seller financing. The cash method of accounting, however, was especially prohibited even if used by both parties. If tax avoidance is the concern that prompted this requirement, we recommend that both the buyer and seller be required to use the same accounting method whether accrued or cash for the transaction. This rule would prevent one party from recognizing income in another time period from when it was paid or received, solving any problems with time value of money.

Conclusion

The OID rules and the imputed interest rules have an application in a perfect world where competition for financing is not based on subjective factors. It is a fact of life that small firms do not exist in a perfect world. They do not have the financial leverage of large firms and cannot attract financing in the same way as large firms. For small business, creative methods of below-market financing are a way of life, since cash is a business' lifeblood. A buyer and a seller must be free, within the bounds of appropriate business practice, to agree on the terms for the sale of an asset or business. It has never been, nor should it ever be, the business of the IRS what the terms of a transaction are, unless the terms of the transaction provide clear evidence of intentional tax avoidance.

NFIB wishes to thank the Committee for its attention to the imputed interest issue, and we look forward to working with you to find an equitable solution.

STATEMENT OF CHARLES FELDEWERT, SECRETARY-TREASURER, BUILDING OWNERS AND MANAGERS ASSOCIATION, INTERNATIONAL AND PRESIDENT/CHIEF FINANCIAL OFFICER OF THE TURLEY MARTIN CO., ST. LOUIS, MO

Mr. FELDEWERT. Thank you, Mr. Chairman. My name is Charles Feldewert. I am president and chief financial officer of Turley Martin Co. in St. Louis. Also, I am the secretary-treasurer of the Building Owners and Managers Association, and I am presenting this testimony on behalf of the members of BOMA. BOMA is a trade association representing the office building industry through 90 local associations located in the United States and Canada. BOMA supports the provisions of the new original issue discount and imputed interest rules that prevent the mismatching of interest income and deductions. However, other provisions of the new rules would effectively end the use of seller financing for larger office buildings in times of high interest rates, thus seriously disrupting the office building industry. BOMA believes that the OID and imputed interest rules are fundamentally flawed because they rely on the presumed relationship between market interest rates and the value of real property. This relationship does not exist other than in the short run, and even in the short run it does not exist when interest rates are in excess of a long-term historic range of interest rates to finance real property.

However, if the rules will continue to use interest rates to test seller-financed transactions, then we strongly urge that the following changes be made. One, that the test rate should be based on the Federal Home Loan Bank Board's cost of funds rather than the applicable Federal rate and should be no more than 100 percent of the COF index. As has been pointed out before, it is more stable than the AFR, and its level generally approximates historic interest rates used in seller-financed transactions. Two, the test rate should have a ceiling designed to prevent increases in the test rate from stopping seller-financing in times of abnormally high interest rates. The gentlemen on the last panel addressed that issue also. Three, if the test rate must be based on the applicable Federal rate, we agree with the parties who previously said that this rate should be at no more than 80 percent of the AFR and should be subject to the ceiling rate described above. Four, in addition to applying less stringent test rates to certain properties or to transactions below certain levels, the rules also should provide a safe harbor for transactions that have attributes which make abuse impossible or extremely improbable for example, obligations with relatively short maturity and relatively high percentages of interest paid currently or transactions involving nondepreciable property. The fifth item that we would suggest is that variable and contingent interest rates—rate loans—should not be strongly discouraged by rules that consider only the base rate when applying the test. Some fair method for testing such increasingly common transactions must be found. Six, assumed debt and existing debt portion of wraparound obligations should not be subject to the test. Such debt would have already passed the test when originally issued and cannot be tailored at the time of a subsequent transaction to the circumstances of buyer and seller. Seven, we believe that, where the buyer and seller use the same accounting method, they should be allowed to use this method for seller-financed transactions. To digress for a moment, the important thing, as stated earlier, is to avoid mismatches. The same accounting method will avoid those mismatches. And finally, we agree that the imputation rate—or we suggest that the imputation rate—should be the same as the test rate. If the test rate is appropriate in the first place, that would be the rate to impute. BOMA supports the bills that have been introduced by Senator Durenberger and Melcher. Mr. Chairman, I thank you for the opportunity to present this statement.

Senator CHAFEE. So, you support the mismatch provision that we have in the present law. Is that right?

Mr. FELDEWERT. Definitely.

Senator CHAFEE. Thank you very much, Mr. Feldewert. Mr. Szymanski.

[Mr. Feldewert's prepared statement follows:]

TESTIMONY OF

THE BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

ON

THE APPLICATION OF THE IMPUTED INTEREST AND INTEREST ACCRUAL RULES

PRESENTED BY

CHARLES FELDEWERT
PRESIDENT AND CHIEF FINANCIAL OFFICER
TURLEY MARTIN COMPANY
ST. LOUIS, MISSOURI

TO

THE COMMITTEE ON FINANCE

OF THE

UNITED STATES SENATE

MAY 20, 1985

STATEMENT

I. INTRODUCTION

My name is Charles Feldewert. I am the President and Chief Financial Officer of the Turley Martin Company of St. Louis, Missouri. Also, I am the Secretary-Treasurer of the Building Owners and Managers Association International (BOMA). I am presenting this testimony on behalf of the members of BOMA International.

BOMA is the trade association representing the office building industry through over 90 local associations located in the United States and Canada. Its more than 5,500 members are office building developers, owners, managers, service companies, and investors, who control over two billion square feet of class "A" office space, or one fourth of the office space in North America.

A. The Office Building Industry

The office building industry provides an essential service to the entire economy -- space for its managers and other white collar employees to work. It has been estimated that in 1985 there are over 700,000 office buildings with 9.5 billion square feet of office space. An estimated 42 million persons are working in office buildings now. This is 40 percent of the U.S. workforce and over 70 percent of the white collar workforce.

In addition, the office building industry contributes directly to GNP and employment via office building staff and service companies. An estimated 5.3 million persons are employed by these buildings in management, maintenance, custodial and other positions. This amounts to 5 percent of U.S. employment, with a building employee payroll of $12.1 billion. An additional $14.5 billion of economic activity is generated through contract building services and another $4.9 billion will be generated by other building expenditures. The cost of operating office buildings is thus about one percent of U.S. GNP.

Furthermore, the value of new office buildings constructed just last year was $26 billion -- 0.7 percent of total U.S. GNP. This construction provided over one half million full-time jobs.

B. Involvement in the Office Building Industry in the Resolution of the Imputed Interest Issue

Office buildings are often sold in transactions involving financing by the seller. This method of financing the sale of office buildings is particularly important when interest rates are high. From 1977 through 1982, for example, many office buildings were sold with seller financing, just as many private homes were, and for the same reason--artificially high interest rates were preventing economic transactions from occurring without seller financing.

For this reason, BOMA has been interested in the original issue discount (OID) and imputed interest rules and has participated in efforts to resolve the problems with the O.I.D. and imputed interest rules enacted by the Deficit Reduction Act of 1984 (the "new rules"). After the enactment of the new rules, BOMA submitted a statement to the Senate Finance Committee urging the Committee to repeal or revise the new rules.

BOMA did not support the Finance Committee's compromise proposal because the proposal failed to solve the major problems that the new rules created, did not resolve important issues in applying the rules to common transactions, and was extremely complex.

BOMA is hopeful that the Committee will report a bill that restricts abusive tax shelters without effectively prohibiting legitimate, economic, seller-financed real estate transactions.

II. THE NEW RULES

Congress enacted the new imputed interest rules to curb abusive, tax-motivated deferred payment transactions. Some of the provisions of the new rules accomplish this objective without unduly interfering with legitimate, economic transactions. For example, we support the requirement that transactions with seller-financed loan amounts under $2 million be accounted for under the cash method by both buyer and seller (presently applicable only to farm properties) and that loans over $2 million be accounted for under the accrual method of accounting by both buyer and seller. These provisions will prevent the mismatching of income and deductions.

However, other provisions of the new rules would curb not only abusive transactions, but also many legitimate, economic, non-tax-motivated transactions as well. The major problem is the interest rate selected under the new rules to test the adequacy of the interest payments -- 110 percent of the yield on federal debt obligations with maturities similar to the term of the seller-financed debt. This test rate bears no relationship to the real market interest rate for real estate loans, especially when interest rates are high and erratic. This is when seller-financed transactions predominate. The test rate would stop seller-financed transactions from occurring in such circumstances.

This and other serious problems with the new rules must be solved before they can accomplish the objective of curbing abusive transactions without unduly restricting legitimate deferred payment transactions.

III. FUNDAMENTAL PROBLEMS WITH THE NEW RULES

A. Background

The original issue discount and imputed interest rules of the tax law govern the timing of interest payment inclusions in and deductions from income. They effectively set a minimum interest rate to be used in a sale of property involving a debt instrument or deferred payments. Original issue discount arises when the borrower agrees to repay (the redemption price) the lender more than he originally borrowed (the issue price). The difference between the redemption and issue prices -- the OID -- performs the same function as interest. The OID rules prevent the mismatching of income and deductions by governing the timing of the seller's inclusion in and the buyer's deduction from income of the interest payment on debt instruments where OID is present.

Imputed interest arises where property is sold and the payment of all or a portion of the purchase price is deferred, resulting in a loan of the deferred amount. The imputed interest rules prevent the overstatement of principal and the understatement of interest by governing the measurement of principal and interest in deferred payment situations and specifying a minimum interest rate that must be used to avoid imputation by the IRS of a higher interest rate.

The new OID and imputed interest rules were enacted because of perceived abuses involving deferred payment transactions of property not traded on securities exchanges, and thus not subject to the old OID rules. Congress was concerned that taxpayers were manipulating the principal amount of the debt by artificially fixing interest at a below-market rate. The supposed purpose of this manipulation is to convert ordinary interest income into capital gains for the seller, and to inflate the tax basis of the property in order to create excessive depreciation deductions and investment tax credits for the buyer.

In order to compute the amount of OID, the issue price of the debt must be known. When a note is issued for cash, the issue price equals the amount of cash received. When a note is issued for property traded on a securities exchange, the issue price equals the listed price of the property. However, in transactions in which the issuer receives nontraded property, the issue price is determined by the fair market value of the property sold. Because a case-by-case, "facts and circumstances" determination of fair market value was considered impractical, Congress chose to determine value by incorporating into the OID rules the test for adequate interest formerly contained in the imputed interest rules.

The test rate is applied to a deferred payment transaction to make "an approximation of the maximum fair market value of property (and hence the issue price of the obligation issued in exchange for it) ... by assuming a minimum rate of interest which parties dealing at arm's length and without tax motivations could be expected to agree upon."[1] This minimum interest rate was set at 110 percent of the applicable federal rate (AFR), which is the average yield on federal obligations with maturities similar to the term of the loan.

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[1] General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Joint Committee on Taxation, 111.

B. Problems

1. The Fair Market Value of Real Property Cannot Be Determined Solely From An Examination of Interest Rates

The new OID and imputed interest rules are fundamentally flawed because the economic model which supports them is oversimplified and inaccurate. The presumed relationship between interest rates on federal obligations and fair market value does not exist, especially when rates are high by historic standards.

The economic model which supports the new OID and imputed interest rules is oversimplified and inaccurate because it assumes that real property is like a coupon bond, the value of which fluctuates inversely with interest rates.

A coupon bond provides a fixed stream of payments over the life of the bond. The value of the bond is the present value of that stream of payments. As interest rates rise, the future payments are discounted by a larger value and the present value of the bond consequently declines.

Real property would respond like a bond to changing interest rates only if this rental stream were fixed over the life of the property. But this is not the case since rental streams are not fixed over the life of the property.

Commercial real property responds to changing interest rates (with all other factors held constant) in a process that leads in the long run not to changing values, but to changing rents. In the short run, rents and the supply of buildings are effectively fixed, so changing interest rates affect value. As interest rates fall, for example, value may increase. However, this change in value stimulates new construction, which increases the supply of buildings, which leads to lower rents, which then lowers values to approximately the original level. The ultimate response to a reduction in interest rates, therefore, is to increase the stock of buildings and reduce rents, but to leave values relatively unaffected.

In addition, when rates are abnormally high, which is when seller financing predominates, or when rates are abnormally low, there is absolutely no relationship between value and interest rates. Interest rates outside the historic range that the parties to the transaction consider likely to prevail in the long run have no effect on value because neither party uses them to discount future cash flows. When interest rates rise, buyers and sellers of real property make a judgment about future, long-run interest rates that will occur over the life of the property. Temporary, aberrant high interest rates are properly ignored and an interest rate is negotiated that permits the sale to occur at a total compensation agreeable to both buyer and seller over the long run. The interest rate used in a seller-financed transaction is determined by long-run historic interest rates, which are the best indicator of long-run future rates, and not by temporary swings in interest rates or by tax considerations.

Therefore, the relationship between interest rates and real property values exists almost exclusively in the short run, and this relationship only exists when interest rates are within a range deemed by the buyer and seller to be reasonable in the long run.

2. The AFR is an Inappropriate Test Rate Index Because The Seller's Cost of Funds for Financing a Sale Is Not the Same as The Treasury's Cost of Funds

There is little relationship between the interest rates the Treasury is forced to pay at any given time and the rates a seller can offer in a deferred payment transaction.

One reason is that when interest rates are high, sellers are not in the market borrowing funds to lend to buyers at lower rates. Real property owners planning to sell their property forecast interest rate movements over a period of years and may refinance their properties at favorable rates. The seller can often allow the buyer to assume the existing mortgage or can use the existing mortgage in a "wraparound" transaction when interest rates are higher at a later date. However, the Treasury is in a different situation. It must borrow, regardless of the prevailing interest rates, when it needs cash to fund the government's obligations. It has very little flexibility to stay out of the market when rates are abnormally high or to go into the market to take advantage of favorable rates.

Another reason is that even if the seller and the Treasury have the same cost of capital, the seller need not demand an interest rate higher than the Treasury on a deferred payment loan. This is because there may be virtually no risk of loss in such a transaction and there are lower transaction costs. Although the probability of default is greater for a debt obligation issued by the buyer than for one issued by the Treasury, there may be little risk of loss in a foreclosure situation because the loan is fully secured by the property sold and the value of the property is known by the lender. In addition, because it is not uncommon for the buyer to invest a substantial sum to renovate a property after purchase, the property may be considerably more valuable upon foreclosure than it was at sale.

A third reason for the difference between Treasury and seller financing interest rates is that the interest rate for debt issued by the seller may be less than for Treasury obligations because the brokers' fees and other transaction costs that are associated with the purchase of the Treasury obligations are not involved in seller-advanced debt.

3. Neither 110 Nor 100 Percent of the AFR is an Appropriate Test Rate Because it Will Stop Seller Financing In Times of High Interest Rates

The AFR for short, medium, and long-term debt is extremely volatile, and 110 percent, or 100 percent, of the AFR reaches peaks in times of high interest rates that are far above long-run historic interest rates. The volatility of 100 percent of the medium-term AFR, which is most likely to be applicable to seller-financed real estate transactions, is compared to the relative stability of the Cost of Funds (COF) Index published by the Federal Home Loan Bank Board (FHLBB) in Graph 1, attached.

The volatility of the AFR results in test rates that reach levels high enough to stop seller financing when market interest rates are high. Under the new rules and the implementing regulations, the test rate applicable to a medium-term loan is the lowest of 110 percent of the six-month average AFR or one of the three previous monthly AFRs. Currently, test rates (110 percent of the AFR) range from 12.47 to 14.75 percent. The bill recently approved by the House Ways and Means Committee would set a test rate equal to 100 percent of the AFR. All of these rates are above current interest rates available from third party lenders.

The test rates prescribed by the new rules deprive buyers and sellers of real property of an essential method of transferring property during occurrences of abnormally high interest rates. They deprive the economy of a needed safety valve at such times. They prevent properties from being transferred from a less efficient to a more efficient use. They prevent the rehabilitation that often occurs when real property is sold. They reduce capital gains tax revenues. Also, they interfere with private contractual relationships to an unreasonable and unjustified extent. We believe that these unintended adverse effects far outweigh any benefits that may derive from curbing the relatively few tax-motivated seller-financed transactions.

C. Solutions

The fact that there is no predictable relationship between interest rates and the fair market value of real property calls into question the entire structure of the new OID and imputed interest rules. These rules simply do not accomplish their purpose, the curbing of tax abuses without stopping non-abusive transactions.

This is why segments of the real estate industry have proposed repeal of the new rules. Indeed, with the exception of the rules to prevent mismatching of interest income and deductions, we continue to believe that repeal of the new rules is the best solution to the problems the new rules create for legitimate, non-tax-motivated transactions.

However, if the new rules will continue to use interest rates as a measure of fair market value, they should be modified to minimize unintended economic dislocations. The new rules should reflect the fact that any calculation of value based on interest rates will be imprecise. Seller-financed transactions are overwhelmingly motivated by a desire to deal with abnormally high interest rates rather than a desire to manipulate capital gains or to inflate basis for tax purposes. For these reasons, where a choice must be made between minimizing the prevention of abuse and minimizing the interference with non-tax motivated transactions, the latter course should be taken.

IV. PROBLEMS AND SOLUTIONS

A. The Test Rate

The current test rate applicable to larger transactions -- 110 percent of the AFR -- is too volatile and often too high to be used as a test rate. We believe that the test rate should be based on a stable index and should not exceed the historical range of interest rates used in real estate transactions.

1. COF Index

We believe that the appropriate index is the Cost of Funds Index and the appropriate test rate should not exceed 100 percent of the COF Index. The COF Index is more stable than the AFR and is a close approximation of usual seller-financed interest rates. This is because it reflects the true costs of seller-financed transactions.

The COF Index is a weighted average of the cost of funds for institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC) (Savings and Loan Associations and Savings Banks). The sources of funds are passbook savings accounts, certificates of deposit, and funds borrowed from the FHLBB. These funds predominantly are used for real property construction.

The COF Index is less volatile than the AFR because S&Ls and savings banks have a flexibility in dealing with the financial markets that the Treasury lacks. This flexibility allows them to minimize changes in their cost of funds by altering their borrowing and lending patterns as interest rates and the supply of funds change.

In seller-financed transactions, there are no loan origination costs ("points," appraisal and title insurance fees, or commissions) and there is no profit for the seller in the loan portion of the transaction. For these reasons, the cost of funds for S&Ls and savings banks is an appropriate measure of seller financing costs. Indices which include these extra costs, such as the lending rates of S&Ls and savings banks, would be approximately two points too high for an appropriate test rate for seller financing.

2. Ceiling Test Rate

There should be a "ceiling" on the test rate to prevent temporary, aberrant levels of the COF Index from stopping seller-financed transactions. As discussed above, aberrant interest rates outside long-run historic interest rates are ignored by buyer and seller in evaluating the value of a property. A ceiling rate would apply this principle to the test rate.

Establishing a ceiling rate also is appropriate in view of the 9 percent "floor" established by the rules. This would provide symmetric treatment and establish the range of relevant, historic interest rates used in real property transactions.

Also, we believe that the historic range of "capitalization rates" (net income/purchase price), which represent the overall yield on current income from real estate, should be considered in setting the ceiling rate. This is the rate customarily used to relate value to current income. A ceiling rate generally no more than 12 percent should be set.

3. 80 Percent of AFR

However, if the test rate must be based on the AFR, it should not exceed 80 percent of the AFR. This level is preferable to the present test rates because the peak levels of 80 percent of the AFR that have been reached in the past have generally been within the range of historically reasonable interest rates. The COF Index and 80 percent of the AFR are compared in Graph 2, attached. This graph shows that 80 percent of the AFR generally gyrates above and below the COF Index by relatively equal amounts.

B. Safe Harbor for Potentially Nonabusive Transactions

Under the new rules, certain categories of property under certain levels of borrowings are subject to a 9 percent test rate rather than the generally higher test rate equal to 110 percent of the AFR. Under the interim rules, borrowings under $2 million are subject to the 9 percent rate. The properties owned by many of our members are not in a favored category and have values far exceeding any threshold level under consideration. We see no reason to have a higher test rate for office buildings with borrowings over $2 million. While we have no objection to an exemption or preferred treatment for certain categories of property or for smaller transactions, we do feel that transactions that are not potentially abusive also should be exempted from the rules or given preferred treatment without regard to their size or nature. This would target potentially abusive transactions while minimizing the impact on other transactions.

A rational basis for accomplishing this would be to specify the attributes of a seller-financed transaction that make tax abuse impossible or extremely improbable. Based on the objectives of the OID and imputed interest rules, the attributes of seller-financed transactions with little or no potential for abuse are:

1) a relatively short maturity;

2) a relatively high percentage of interest paid currently; or

3) nondepreciable property.

The amendment that passed the Senate last year contained a provision that set a lower test rate for seller-financed transactions with maturities less than 2/3 of the ACRS life (12 years) and with more than 80 percent of the interest paid currently. This type of transaction was deemed less likely to indicate an abusive transaction because of the relationship between depreciation and interest deductions. The "2/3 of ACRS life and 80 percent paid currently" test is reasonable and should be considered by the Committee.

Property that is not depreciable by the buyer, such as raw land and structures not used in a trade or business, should be exempt from the rules or subject to a lower test rate because there can be no excessive depreciation or deduction caused by basis inflation. By exempting nondepreciable property, all residences and farm land would be exempted.

C. Variable and Contingent Rate Debt

The new OID and imputed interest rules strongly discourage the use of variable and contingent rate loans. Variable rate loans are keyed to an index such as the Consumer Price Index or a Federal rate. Contingent rate loans have additional interest payments that are dependent on the amount of net operating income. The interest payments on such loans cannot be estimated when the transaction occurs, and the test rate is therefore applied only to the base interest rate. The base rate is set lower than other market interest rates to take account of the cash flows of the buyer over time. Applying the test rate to the base rate biases the test against these common types of loans.

This problem is further evidence of the fundamental flaw in the underlying basis for the new rules -- the assumed relationship between value and interest rates. Value cannot be inferred from interest rates in such transactions.

We urge Congress to develop workable solutions to the problem of fairly evaluating these transactions under the rules.

D. Assumptions and Wraparounds

The OID and imputed interest rules are unique in the Internal Revenue Code because they use interest rates to infer fair market values of real property. For the purpose of these rules, we believe that all assumed debt, and the existing debt portion of wraparound debt, should not be subject to the rules. Only the new debt portion of a wraparound debt should be subject to the test.

This is because the purpose of the OID and imputed interest rules is to stop buyers and sellers from tailoring interest rates for tax-motivated reasons and charging inadequate interest. Debt that is assumed, taken subject to, or used in a wraparound transaction cannot be tailored, since its terms are fixed before the transactions between the buyer and seller take place.

In addition, such debt either would have been issued before the new rules were in place or would have passed the test when originally loaned.

E. Mismatch Prevention

As discussed above, we support rules which will stop the mismatching of income and deductions of taxpayers with different accounting methods. We believe that requiring cash accounting for smaller transactions and accrual accounting for larger transactions is an acceptable solution. However, we believe a better solution would be to allow the parties to use either system if both parties already use one or the other and to require them both to use accrual accounting if either party uses this method.

F. Imputation Rate

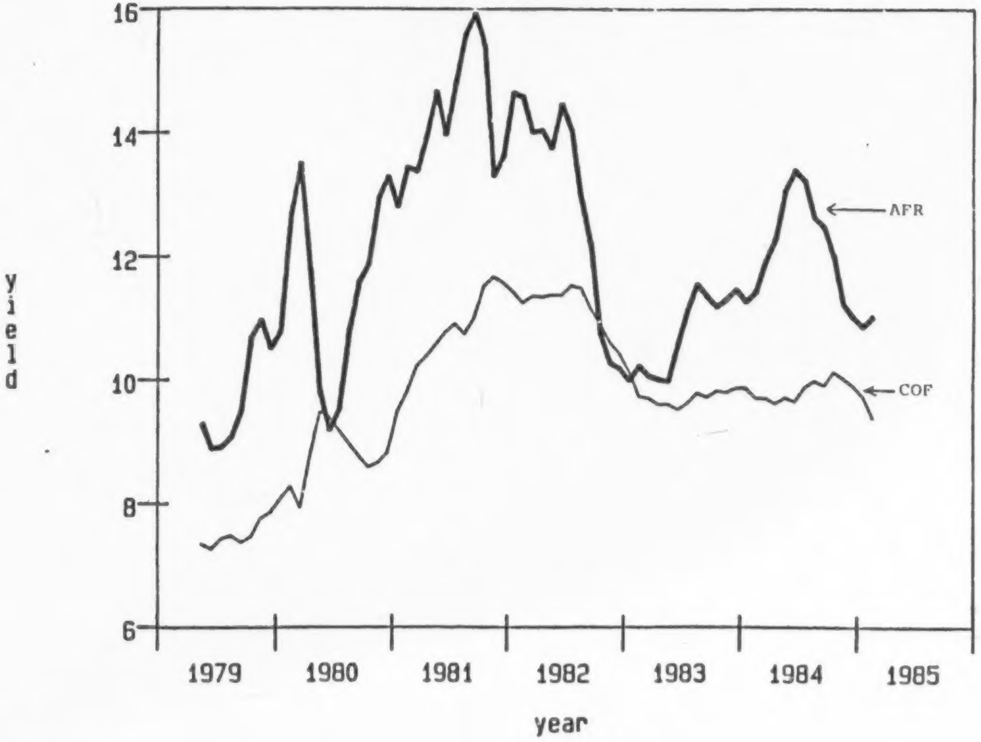
Since the purpose of the test rate is to determine the fair market value of property and insure that this value is used for tax purposes, we believe that the imputation rate should be the same as the test rate. Once an interest rate is determined to result in some approximation of fair value, the rules should operate to insure the adequacy of this value, not to provide a penalty.

V. CONCLUSION

BOMA believes that the new rules should be repealed, with the exception of the provisions that prevent the mismatching of income and deductions. However, if the new rules will continue to use interest rates to measure fair market value, we recommend that the rules be substantially modified so as to minimize the economic dislocations caused by interference with legitimate, economic seller-financed transactions.

GRAPH I

APPLICABLE FEDERAL RATE, MID-TERM MATURITY
(U.S. TREASURY 3-9 YR. MATURITY) (bold);
AND FHLBB COST OF FUNDS (line)



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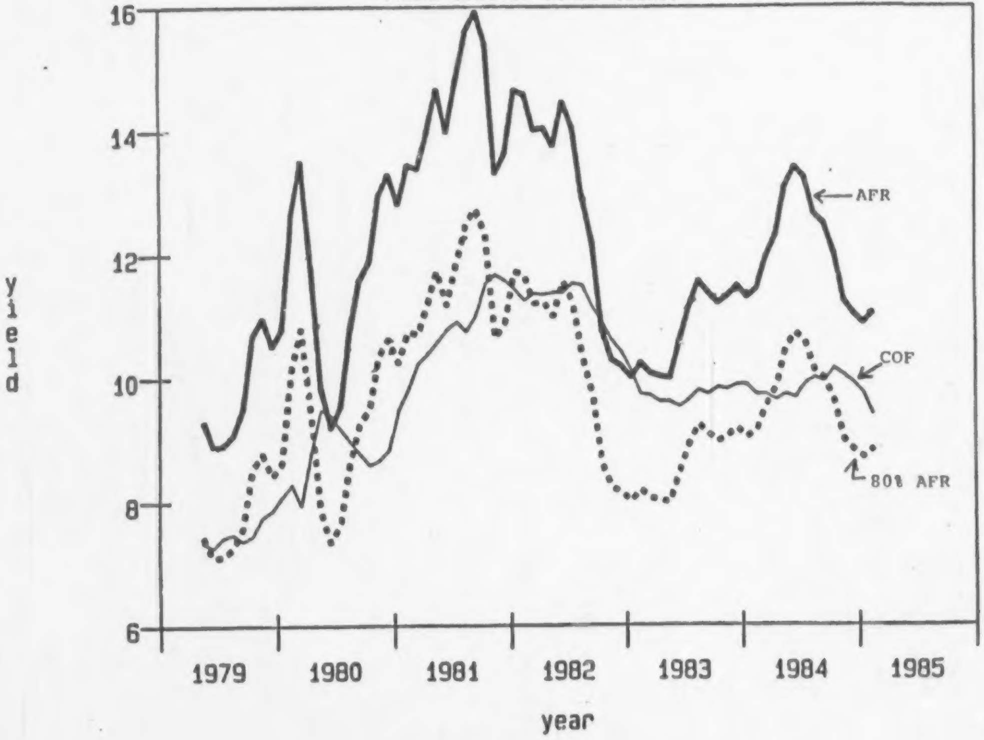
[illegible]

100 PERCENT (bold) AND 80 PERCENT (bold, dotted) OF THE APPLICABLE FEDERAL RATE, MID-TERM MATURITY (U.S. TREASURY 3-9 YR. MATURITY) AND FHLBB COST OF FUNDS (line)



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STATEMENT OF JOHN SZYMANSKI, GOVERNMENT AFFAIRS COMMITTEE, INTERNATIONAL COUNCIL OF SHOPPING CENTERS AND VICE PRESIDENT AND DIRECTOR OF TAXES, ROUSE CO., COLUMBIA, MD

Mr. **Szymanski**. Mr. Chairman and members of the subcommittee, my name is John Szymanski. I am a vice president and director of taxes of the Rouse Co., a publicly traded real estate company just a few miles down the road in Columbia, MD. I am presenting this testimony today on behalf of the International Council of Shopping Centers. ICSC represents about 90 percent of the shopping center industry. I am a member of the ICSC Government Affairs Committee and its Legislative Tax Subcommittee.

Senator **Chafee**. Let me ask you this. Why is it called international? Do you have international or foreign members?

Mr. **Szymanski**. Yes, we do have Canadian members and also several members in England, France, and other countries. I have with me our Washington Counsel today, Edward Mader of Winston & Strawn. ICSC supports the provisions of the new rules that would stop abusive seller-financed transactions by preventing the mismatching of income and deductions and requiring the use of compounded test rates. And we are in agreement with the other real estate organizations with respect to those types of abusive transactions. However, ICSC opposes excessively high test rates and other provisions that would stop or substantially curtail legitimate, non-tax-motivated seller financing transactions, especially in times of abnormally high interest rates where seller financing is critical. The test rates are too high because they are based on a fundamentally flawed premise that the value of real estate fluctuates directly with changes in Federal interest rates. The value of real estate does not respond to changes in interest rates in a predictable fashion and does not respond at all to temporary or abnormal changes in Federal interest rates especially. Rather, real estate values are influenced by historic interest rates, which are the best predictors of the range of interest rates likely over the relatively long life of the property. The Treasury Department's primary focus seems to be on relatively small transactions, and those factors are basically irrelevant for large transactions.

The following changes in the new rules are needed to target potentially abusive transactions while not curtailing legitimate economic transactions. One, the test rate should be equal to 80 percent of the AFR or should equal the Federal Home Loan Bank Board's cost of funds index, which is much more stable than the AFR and reflects the actual cost of financing real estate. And in our testimony, there is a chart indicating the relationship between Federal rates and the Federal Home Loan Bank Board's cost of funds index. In addition, taxpayers should be able to utilize a rate less than the test rate if they can show such rates are available from third party lenders. Two, there should be a ceiling on the test rate, either a fixed cap rate or a variable rate equal to a fraction of the difference between the cap and the AFR. Three, transactions that are not potentially abusive because their term is relatively short compared to the ACRS life, for example two-thirds of the ACRS life or 12 years, and where a high percentage of the interest is paid currently—say, for example, more than 80 percent, or where the property is nondepreciable in the hands of a buyer—it should be subject to a less stringent test and should benefit from a test rate cap. The focus should not be on the amount of the transaction but on one of abusive transactions. Four, neither assumed debt nor the existing debt portion of wraparound loans should be subject to the test.

We do not believe that changes proposed above would have any negative revenue impact. However, the committee report on the House bill shows that it raises more revenue by extending the ACRS life from 18 to 19 years than the amount of revenue lost by providing relief for the smaller transactions. Therefore, any revenue loss from these changes, we propose, should be paid for by the surplus. We have several examples which we would like to supply to the staff of these safe harbor rules which would indicate, I think pretty clearly, that through this technique of the safe harbor there would be relatively little or no revenue impact. ICSC supports Senate bill 729 introduced by Senator Durenberger and supports Senate bill 217 introduced by Senator Melcher. Thank you for this opportunity to testify.

Senator CHAFEE. Thank you very much, Mr. Szymanski. Mr. Driesler.

[Mr. Szymanski's prepared statement follows:]

TESTIMONY OF

THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

ON

THE APPLICATION OF THE IMPUTED INTEREST
AND INTEREST ACCRUAL RULES

PRESENTED BY

JOHN J. SZYMANSKI
VICE-PRESIDENT AND DIRECTOR OF TAXES

THE ROUSE COMPANY
COLUMBIA, MARYLAND

TO

THE COMMITTEE ON FINANCE

OF THE

UNITED STATES SENATE

MAY 20, 1985

STATEMENT

I. INTRODUCTION

My name is John J. Szymanski. I am a vice-president and the Director of Taxes of The Rouse Company of Columbia, Maryland. We are real estate owners, developers, and managers. I also a member of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and I am presenting this testimony on behalf of the members of ICSC.

ICSC is the trade association of the shopping center industry. ICSC has approximately 12,000 members, consisting of shopping center developers, owners, operators, tenant retailers, lenders, and related enterprises. The ICSC represents a majority of the 25,000 shopping centers in the United States.

A. The Shopping Center Industry

It is estimated that in 1984 shopping centers accounted for 45 percent of total U.S. retail sales, and that this figure will increase to between 50 percent and 55 percent by 1990. In current dollar value, U.S. shopping center retail sales reached a level of $475 billion in 1984.

It also is estimated that between 5.7 and 6.5 million people are regularly employed in shopping centers and that several hundred thousand more are annually engaged in new construction, expansion, and renovation of shopping centers. The effect of shopping center development on employment in related businesses, including the manufacture of goods sold in the centers, advertising, maintenance and cleaning, and accounting is considerable.

B. Involvement of the Shopping Center Industry in the Resolution of the Imputed Interest Issue

Seller financing has been a very important factor facilitating the sale of shopping centers and has proven to be essential when interest rates are high by historic standards because legitimate economic transactions would not have occurred without it.

For this reason, ICSC's members are affected by the extension of the original issue discount (OID) rules to real property transactions and the revised imputed interest rules. ICSC has participated in efforts to resolve the problems with the new original issue discount and imputed interest rules (the "new rules") enacted by the Deficit Reduction Act of 1984. After the enactment of the new rules, ICSC testified before the Senate Finance Committee and participated in discussions with the Treasury, the Joint Committee on Taxation, and the Senate Finance Committee regarding amendments to the new rules.

However, ICSC did not support either of the products of these discussions: the compromise proposal and the interim rules which were enacted in mid-October, 1984. These proposals failed to solve the major problems that the new rules created for commercial real property transactions, did not resolve serious unfairness in applying certain of the new rules to certain common transactions, and were extremely complex.

ICSC is hopeful that the Committee can develop a more equitable permanent resolution of the issues concerning OID and imputed interest than either the new rules or the interim rules. ICSC also is hopeful that the Committee will be able to restrict abusive tax shelters, without decreasing Federal revenues by effectively eliminating legitimate, economic real estate transactions that are not substantially tax-motivated.

II. THE NEW RULES: A FLAWED SOLUTION

The objective of Congress in enacting the new rules was to curb abusive, tax-motivated deferred payment transactions. Some of the provisions of the new rules accomplish this objective without unduly interferring with legitimate, economic transactions. For example, the requirement that seller-financed loans under $2 million be accounted for under the cash method by both buyer and seller (presently applicable only to farm properties) and that loans over $2 million be accounted for under the accrual method of accounting by both buyer and seller might prevent the mismatching of income and deductions. Although this provision will require that some taxpayers change their accounting system for deferred payment transactions, it is an appropriate method of preventing abuses. Another example of an appropriate change is the requirement that interest be calculated on a compounded basis in applying the test rate. We support this change because it reflects economic reality.

However, many other provisions of the new rules, in attempting to curb transactions perceived by Treasury to be abusive, would curtail many legitimate, economic transactions as well. This is primarily because of the excessive test rate selected to infer the fair market value of the property sold in a seller-financed transaction involving most commercial and rental residential real estate, i.e., 110 percent of the interest rate on federal debt obligations with maturities similar to the term of the seller-financed debt. This test rate bears no relationship to the fair market value of real property or to the actual market in non-tax-activated, seller-financed real property transactions. This is especially so when interest rates are high and changing rapidly, which accentuates the demand for seller-financed transactions. The unrealistically high test rate would stop or substantially curtail seller-financed transactions in such circumstances.

In addition, the new rules fail to provide reasonably for assumptions and wraparounds, for contingent and variable rate loans, or for imputed non-deductible capital losses and interest.

These and other serious problems with the new rules must be solved before the rules can accomplish the objective of curbing abusive transactions without unduly restricting legitimate transactions.

III. FUNDAMENTAL PROBLEMS WITH THE NEW RULES

A. Background

The original issue discount (OID) and imputed interest rules of the tax law govern the timing of interest payment inclusions in and deductions from income and effectively set a minimum interest rate to be used in a seller-financed sale of property involving a debt instrument or deferred payments. Original issue discount arises when the borrower agrees to repay the lender (the redemption price) more than he originally borrowed (the issue price). The difference between the redemption and issue prices, the OID, performs the same function as interest. The OID rules prevent the mismatching of income and deductions by governing the timing of the seller's inclusion in income and the buyer's deduction from income of the interest payment on debt instruments where OID is present.

Imputed interest arises where property is sold and the payment of all or a portion of the purchase price is deferred, resulting in a loan of the deferred amount. Imputed interest rules are intended to prevent the overstatement of principal and the understatement of interest by governing the measurement of principal and interest in deferred payment situations and specifying a minimum interest rate that must be used to avoid imputation of a higher penalty interest rate.

Congress enacted new OID and imputed interest rules because of perceived abuses involving deferred payment transactions of property not traded on securities exchanges, and thus not subject to the old OID rules. Congress was concerned that taxpayers were manipulating the principal amount of the debt by artificially fixing interest at a below-market rate. The alleged purposes of this perceived manipulation are to convert ordinary interest income into capital gains for the seller and to inflate the basis of the property in order to create excessive depreciation deductions and investment tax credits for the buyer.

As discussed above, in order to compute the amount of OID, the issue price of the debt must be known. Where the debt is issued for cash or a traded security, the issue price equals the amount of cash received or the listed price of the security. However, in transactions where the issuer receives nontraded property, the issue price is determined by the fair market value of the property sold. Because a case-by-case, "facts and circumstances" determination of fair market value was considered impractical, Congress chose to apply the OID and imputed interest rules to real estate and to determine value by applying the same test interest rates used to test the adequacy of interest payments under the imputed interest rules.

As explained by the Joint Committee on Taxation, the purpose of applying the test rate to a deferred payment transaction of nontraded property is to make "an approximation of the maximum fair market value of property (and hence the issue price of the obligation issued in exchange for it) ... by assuming a minimum rate of interest which parties dealing at arm's length and without tax motivations could be expected to agree upon."1/

1/ General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Joint Committee on Taxation, 111.

This minimum interest rate is set at 110 percent of the applicable federal rate (AFR) for transactions other than those involving principal residences, farms under $1 million, and other sales under $250,000, which are subject to a 9 percent test rate. The AFR is the average yield on federal obligations with maturities similar to the term of the loan. The stated rationale for this test rate is that this is "a reasonable approximation of the rate at which a good credit risk with adequate security would borrow.[2]

B. Problems

1. The Fair Market Value of Real Property Cannot Be Determined Solely From An Examination of Interest Rates on Federal Debt Instruments

Parties to seller-financed real property transactions dealing at arms length and with no tax motivations generally agree on interest rates well below the test rates established by the new rules. This fact is not consonant with the intended operation of the new rules because the economic theory underlying the new rules is fundamentally flawed.

The relationship between interest rates and the fair market value of real property is much more complex than the economic model which purports to support the new rules. The simple inverse relationship between interest rates and value, which the new rules presume, simply does not exist. In addition, over the range of interest rates of most importance under the new rules, when rates are high by historic standards, there is no relationship whatsoever between federal interest rates and the fair market values of real property.

a. Real Property Does Not Respond Like a Bond to Changing Interest Rates Because Its Essential Financial Attributes are Completely Different From the Attributes of a Bond

The new rules presume that real property is like a coupon bond, and that the value of real property is presumed to fluctuate inversely with interest rates just as do bond values.[3] A coupon bond provides a predetermined stream of payments over the life of the bond and a predetermined payoff at maturity. The value of the bond is the present value of that stream of payments, including the payoff at maturity. As interest rates rise, the future payments are discounted by a larger value and the present value of the bond consequently declines.

Real property would respond like a bond to changing interest rates only if the net operating income (the rental stream less operating costs) were predetermined over the life of the property and if the ultimate sale price of the property were predetermined. However, neither the rental stream, nor the operating costs, nor the sale price of real property is predetermined and all are subject to inflationary influences. This is why real property does not respond like a bond to changes in interest rates.

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[2] *Id.* at 115, n. 24.

[3] *See id.*

b. In the Long Run, Changing Interest Rates Affect Rents and the Stock of Buildings Rather Than Values

In fact, commercial real property responds to changing interest rates (when all other factors are held constant) in a complex three-stage process that leads not to changing values, but to changing rents. In the short run, rents and the supply of buildings are effectively fixed, so changing interest rates tend to affect value. As interest rates fall, for example, value may increase (assuming that the buyer is free to mortgage with current market financing.) This change in value stimulates new construction, which increases the supply of buildings, which leads to lower rents, which in turn leads to a lower value approximating the original value. In the long run, therefore, the ultimate response to a reduction in interest rates is to increase the stock of buildings and reduce rents, but to leave values relatively unaffected.

c. When Interest Rates are Outside the Historic Range of Rates Used in Real Property Transactions, They Have No Effect on Values

In addition, when market interest rates are abnormally high, which is when seller-financed transactions predominate because conventional financing is limited or unavailable, there is absolutely no relationship between value and interest rates. Interest rates outside the historic range that the parties to the transaction consider likely to obtain in the long run have no effect on value because neither party uses them to discount future cash flows.

This is because real property is a long-lived asset which justifies the long-term loan commitments common to real property financing. Unlike perishable commodities, real property is not subject to forced sale other than in foreclosure situations. When interest rates rise, buyers and sellers make a judgment about the future, long-run interest rates that will occur over the life of the property and its financing. Temporary, aberrant high interest rates properly are ignored by the buyer and seller and an interest rate is negotiated that permits the sale to occur at a total compensation agreeable to the buyer and seller over the long run. The seller-financed interest rate is determined by long-run historic interest rates, which are the best indicator of long-run future rates, and not by temporary swings in interest rates or tax considerations.

In addition, even in the long run, changing interest rates do not produce changes in value beyond certain limits. This is clearly demonstrated by considering the situation when interest rates decline. The increase in the value of a building as interest rates decline is limited by a "ceiling" value generally equal to the cost of constructing an equivalent new building. The value cannot rise substantially above the ceiling regardless of how low interest rates go. Indeed, if the owner has a long term mortgage and is unable to prepay the loan and refinance at the new, lower rates (because of prepayment prohibitions or penalties), the value of the property to him may fall. This is because, as interest rates decline, competitors with newer, lower interest rate loans would have lower debt service costs and, therefore, could charge less rent, putting downward competitive pressure on his rents.

Similarly, when interest rates climb, the value of a building does not fall below a "floor" level regardless of how high interest rates go. The owner with an existing lower interest rate mortgage does not have increased interest costs. Indeed, he has an advantage over competitors with newer, higher interest rate loans and higher debt service because he can charge less rent than they can. This advantage may be passed along to a buyer through an assumption or wraparound of the original mortgage.

Therefore, the relationship between interest rates and real property values is very limited and exists almost solely in the short run, and this relationship only exists when interest rates are within a range deemed by the buyer and seller to be within the historic range of real property financing rates.

d. Interest Rates Play Little Part In Determining The Sale Price Of Real Property

Market interest rates play little part in determining the sale price of a property. This is because sellers cannot inflate the initial offering price for their properties without discouraging broker and buyer interest and because the seller-financing rate is not a primary factor in motivating the buyer or seller to reach agreement.

The most common method for selling real property is to list a property for sale at a price deemed appropriate by the seller. This price is not related to a seller-financing interest rate. Indeed, many listings recite as terms "cash or arrange", which means that the seller will sell for cash or will seller-finance at the asking price. Listings where the initial offer price (which can only be negotiated down, not up) has been inflated as a tradeoff for lower interest rates are most uncommon. Overpriced listings rarely receive the attention from brokers or buyers commonly shown to other listings.

The price paid for income producing real property, its fair market value, is determined by the motivations of the buyer and the seller. The major motivations involve the uses which the parties forsee for the property, their expectations about future cash flows and residual values, and emotional decisions (rational or irrational) such as decisions not to sell at a loss (even where there has been a reduction in value). The process of negotiating a sale is virtually always to first agree on a price and then to set the financing terms.

Only the boldest and most sophisticated sellers would even suggest a tax-motivated interest-price manipulation because of its complexity and because such an approach would discourage broker and buyer investigation and run counter to the normal negotiating procedure of setting price first and financing terms later. To assume that such a technique is common to the majority of seller-financed transactions clearly is contrary to experience in the marketplace.

2. Interest Rates In Seller-Financed Transactions Are Not Related to Treasury Interest Rates

It is inappropriate to compare the interest rates the Treasury is forced to pay at any given time to the rates a seller can offer in a deferred payment transaction for the following reasons.

First, the seller may have underlying debt which was borrowed at an earlier time when rates were lower. Sellers have no need to go into the market to borrow funds to lend to buyers. Real property owners planning to sell their property forecast interest rate movements over the term of the buyer's note and would rarely be influenced by current rate levels of Treasury obligations. The sale price is often lower because the seller can allow the buyer to assume the existing favorable mortgage or can maintain the existing favorable mortgage in a "wraparound" transaction so that the overall rate charged to the buyer is reduced without decreasing the sellers' net interest yield expectations.

The Treasury is in a different situation. It must borrow, regardless of the prevailing interest rates, when it needs cash to fund the government's obligations. It has very little flexibility to stay out of the market when rates are abnormally high or to go into the market to take advantage of favorable rates.

Second, even if the seller and the Treasury (or other conventional lender) had the same cost of capital, the seller could still offer a lower interest rate on the deferred payment loan. This is because the risk of loss in such a transaction may be extremely low and there are lower transaction costs. Although the probability of default is greater for a debt obligation issued by the buyer than one issued by the Treasury, there may be very little risk of loss in a foreclosure situation because the loan is fully secured by the property sold, and the value of the property is known by the seller-lender. In addition, because it is not uncommon for the buyer to invest a substantial sum to renovate or upgrade a property after purchase, the property may be considerably more valuable upon foreclosure than it was at sale.

Third, the interest rate for debt issued by the seller may be less than for Treasury obligations because there are brokers' fees and other transaction costs associated with the purchase of the Treasury obligations, but not with seller-financed debt.

3. The AFR Is Not an Appropriate Index for Determining a Test Rate Because of its Volatility; Neither 110 Percent Nor 100 Percent of the AFR Is an Appropriate Test Rate Because it Will Stop Seller Financing in Times of High Interest Rates

The AFR for short, medium, and long-term debt is extremely volatile and reaches peaks in times of high interest rates that are far above long-run historic interest rates. This volatility results in test rates that reach levels high enough to stop potential seller financing, particularly when market interest rates are high. The Treasury has issued new test rate regulations designed to minimize the "time lag" problem caused by differences between current market rates and the test rates based on Federal debt rates that occurred some time prior to the application of the test rate. Under these regulations, the test rate applicable to a loan is the lowest of 110 percent of the six-month average AFR or any of the three previous monthly AFRs. Currently, these test rates range from 12.47 to 14.75 percent. The bill recently approved by the House Ways and Means Committee would set a test rate equal to 100 percent of the AFR. All of these substantially different rates are above the level of interest rates currently available for income-producing commercial real property financing from third party lenders.

A test rate equal to 110 percent, or 100 percent, of the AFR stops transactions and deprives buyers and sellers of real property of an essential method of transferring property. It prevents properties from being transferred from a less to a more efficient use. It prevents the rehabilitation that often occurs when real property is sold. It reduces capital gains tax revenues. It interferes with private contractual relationships to an unreasonable and unjustified extent. And it raises the cost of financing, and therefore of operating, real property. This is particularly so during the periodic occurrences of abnormally high interest rates, when it deprives the economy of a needed safety valve by facilitating transactions when institutional loans are unavailable.

Most seller-financed real property transactions would be subject to the medium-term or long-term AFR. The relative volatility of such AFRs is demonstrated on the attached exhibits. Graph 1 compares 100 percent of the medium-term AFR, which has been approximately 40 basis points below the long-term AFR over the period of time covered by the currently applicable AFRs, to the Cost of Funds (COF) Index published by the Federal Home Loan Bank Board (FHLBB). Graph 2 depicts the relationship between 80 percent of the medium-term AFR (80 percent of the long-term AFR is approximately 40 basis points higher) and the COF Index.

C. General Solutions

The lack of a predictable relationship between interest rates and the fair market value of real property is a fundamental problem that calls into question the entire structure of the new OID and Imputed Interest rules. This is why segments of the real estate industry have proposed repeal of the new rules. With the exception of the provisions which prevent the mismatching of interest income and deductions, we believe that repeal of the new rules is the best solution to the problems the new rules create for legitimate, non-tax-motivated transactions.

However, if this deeply flawed system is retained, it should be modified to minimize unintended economic dislocations. The rules should reflect the facts that any calculation of value based on interest rates will be imprecise, and that a variety of motivations influence sellers to dispose of real property at fair market values and to finance the sale at traditional, reasonable rates, rather than a desire to manipulate capital gains or to inflate basis for tax purposes. For these reasons, where a choice must be made between minimizing the possibility of abuse and minimizing interference with non-tax-motivated transactions, the latter course should be taken.

IV. ISSUES AND PROPOSED SOLUTIONS

A. Selection Of An Appropriate Test Rate

As discussed above, 110 percent of the AFR is too volatile and frequently has resulted in interest rates too high to be used as a test rate. We believe that the test rate should be based on a more stable index and should in no case exceed the historical range of average interest rates used in real estate transactions.

In addition, there should be a "ceiling" on whatever test rate is employed, to prevent abnormally high levels of the test rate from stopping seller-financed transactions. As discussed above, fluctuating, aberrant, government-financing interest rates are ignored by buyer and seller in evaluating the sale price (value) of a property, and seller financing rates are more closely related to historic, long-run financing experience. A ceiling rate would apply this principle to the new rules. Establishing a ceiling rate also is appropriate in view of the 9 percent "floor" established by the rules.

We suggest that an appropriate ceiling would be the long-term, average capitalization rate on income-producing real property. The capitalization rate is the ratio of the current net operating income before debt service to the price. This ratio is a "rule of thumb" which is customarily calculated after the purchase has occurred and is then used to project the ultimate sale price of the property based on projections of net operating income over the expected holding period for the property. This ratio reflects the present value of future cash flows and residual values. Thus, the capitalization rate reflects the discount rate used to relate a present income level to a future sale price.

1. COF Index

We believe that one appropriate index is the Cost of Funds (COF) Index, and the appropriate test rate should not exceed 100 percent of the COF Index. The COF Index is much more stable than the AFR and is a reasonable approximation of usual seller-financed interest rates.

The COF Index is a close approximation of the rates actually used in real estate transactions. The COF Index is a weighted average of the cost of funds for institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC)--Savings and Loan Associations and Savings Banks. The sources of funds measured by this index are passbook savings accounts, certificates of deposit, and funds borrowed from the FHLBB. These funds are predominantly used to finance real property construction and acquisition.

The COF Index is less volatile than the AFR because S&Ls and savings banks have the flexibility of other private institutions and individuals in dealing with the financial markets. The ability of these private institutions to respond to changing interest rates and the supply of funds allows them to moderate the changes in their cost of funds.

For example, when an S&L expects rates to rise, it sells long-term CDs and seek to deter withdrawals through marketing and other means. When rates rise, the demand for loans drops and the S&Ls need to attract funds also drops. Therefore, higher interest rate borrowings form a lower proportion of the S&L's total borrowings. These actions keep their cost of funds (and the COF index) from rising as fast as other interest rates. As interest rates fall, new construction is stimulated and borrowing demand increases. This increased demand will keep the S&L's cost of funds from dropping as fast as other interest rates.

In seller-financed transactions, there are no loan origination costs ("points," origination fees, appraisal and mortgage title insurance fees, and commissions) and there is no profit for the seller in the loan portion of the transaction. For these reasons, the cost of funds for S&Ls is an appropriate measure of seller financing costs. Indexes which include these costs, such as the lending rates of S&Ls, would be approximately two points too high for a test rate.

2. Variable Percentage of Applicable Federal Rate

If it is determined that the AFR must be the basis for the test rate, another option for improvement is to moderate the volatility of the AFR. This can be done by setting the test rate equal to a base rate plus some fraction of the difference between the AFR and the base rate.

For example, the test rate could equal 100 percent of the AFR at interest rates at or below 9 percent, and equal 9 percent plus one half of the difference between the AFR and 9 percent when the AFR exceeds 9 percent. Thus, if the AFR is 19 percent, the test rate would be 14 percent (9 percent plus one half of the 10 percent difference between 9 and 19 percent).

3. 80 Percent of Applicable Federal Rate

Another option would be to set the test rate at 80 percent of the AFR. This approach is preferable to the present test rate because the peaks of 80 percent of the AFR that have been reached in the past when rates were increasing have generally been within the range of historically reasonable interest rates. Because of the AFR's volatility, however, there should be a cap on any test rate based on the AFR to account for extraordinary short-term fluctuations which bear little relationship to historic average interest rates over the term of the seller-financed debt.

4. Fixed 10 Percent Compounded Test Rate

Another approach would be to recognize that over a long period of time the capitalization rate used to calculate the value of commercial real property from operating income has been approximately 10 percent. This compounded 10 percent interest rate would be a significant increase over the 9 percent simple interest rate provided in the old Section 483 imputed interest rules.

5. Rates Adjustable by the Treasury

Another approach is to reinstate the Section 483 test rate provisions applicable prior to the new rules, which rates were adjustable from time to time by regulation to reflect necessary changes due to changing market conditions.

B. Lower Test Rates for Transactions That Are Not Potentially Abusive

Under the new rules, certain categories of property under certain levels of borrowings are subject to a 9 percent test rate rather than the 110 percent of AFR test rate. Under the interim rules, borrowings under $2 million are subject to the 9 percent test rate. We see no reason why the size of the borrowing or the nature of the property should create a presumption of tax abuse. While we have no objection to preferred treatment for certain types of property or for smaller transactions, we do feel that transactions that are not potentially abusive, without regard to their size or the nature of the property, also should be exempted or given preferred treatment. This would target potentially abusive transactions while minimizing the impact on other transactions.

We believe that a rational basis for excluding transactions from the rules or applying a test rate less likely to impair legitimate transactions is to exempt seller-financed transactions with attributes that make tax abuse impossible or extremely improbable. Based on the objectives of the OID and imputed interest rules, such attributes of seller financing are:

1) a relatively short maturity;

2) a relatively high percentage of interest paid currently; or

3) nondepreciable property.

One provision of the amendment that passed the Senate last year provided a lower test rate for seller-financed transactions with maturities less than 2/3 of the ACRS life (12 years) and with more than 80 percent of the interest paid currently. This type of transaction was deemed less likely to indicate an abusive transaction because of the relationship between depreciation and interest deductions.

The "2/3 of the ACRS life and 80 percent of interest paid currently" test is reasonable and should be adopted by the Committee.

Property that is not depreciable by the buyer, including personal use property such as residences and investments such as certain farms and raw land, also should be exempt from the rules or subject to a lower test rate because imputation would decrease federal revenues. Since real property depreciation is substantially limited to assets held for use in a trade or business or for production of income, and the investment credit is even more limited, there can be no excessive depreciation deduction or investment tax credit caused by basis inflation.

The increased federal revenues from exempting nondepreciable property from the rules would result because if there is no mismatch of interest income and deductions by the seller and buyer, the revenue effect caused by imputing interest income and deductions would be neutral, or even biased toward federal tax liability should the buyer be subject to investment interest deductibility limitations. In addition, the capital gains tax on disposition would be reduced if imputation recast the sale price downward.

Such an exemption from the rules also would remedy the inequitable consequences of the new rules regarding nondeductible capital losses of investment assets, as discussed in part "F" below.

C. Equitable Treatment of Variable and Contingent Rate Loans

The new rules strongly discourage the use of variable and contingent rate loans. The interest rate of a variable rate loan is keyed to an index such as Consumer Price Index or a Federal rate. The actual interest rates over the term of the debt cannot be determined at the time of sale when the test is applied. Contingent rate loans have additional interest payments that are dependent on the amount of net operating income or gross rental income. The interest payments in such loans cannot be estimated when the transaction occurs and, therefore, the test rate is applied only to the base interest rate. The base rate is set lower than other market interest rates to take account of the cash flows of the buyer over time. Applying the test rate to the base rate biases the test against these common types of loans.

This problem is further evidence of the fundamental flaw in the underlying basis for the new rules: the erroneously assumed relationship between value and interest rates. Value cannot be inferred from interest rates in such transactions.

We urge Congress to develop workable solutions to the problem of fairly treating these transactions under the rules.

D. Related Third Party Debt: Assumptions and Wraparounds

For the purposes of these rules, which are unique in the Internal Revenue Code because they use interest rates to infer the fair market value of real property, we believe that related third party debt (assumed debt, debt taken subject to, and the existing debt portion of a wraparound loan) should not be subject to the rules. Only new seller-financed debt and the new debt portion of a wraparound debt should be subject to the test.

This is because the purpose of the OID and imputed interest rules is to stop buyers and sellers from tailoring interest rates for tax-motivated reasons and charging inadequate interest. Debt that is assumed, or taken subject to, on the existing debt portion of a wraparound transaction cannot be tailored because their terms are fixed before the transactions between the buyer and seller takes place. In addition, such debt either would have been issued before the new rules were in place or would have passed the test when originally loaned.

Additionally, if the Treasury's announced reason for requiring sellers to charge interest rates comparable to those which institutional lenders would charge were a valid basis for the new rules, then sellers should not be required to charge a greater rate than institutional lenders would charge on the portion of the wraparound loan provided by the seller. When underlying third-party financing exists which can be maintained or assumed, then the seller's required test rate should apply only to the seller's equity.

Accordingly, in the case of an assumption, the rate should apply solely to net financing provided by the seller, exclusive of assumed third-party financing.

In the case of wraparound financing (whether by all-inclusive mortgage, contract of sale, contract for deed, etc.), the test rate should be applied to the interest rate on the seller-financed debt, calculated by comparing the seller's equity in the wraparound loan (the amount by which the principal amount of the loan exceeds the balance of the underlying debt) and the interest payments retained by the seller after paying out to the third party lender the interest payments on underlying debt. For example, assume that the principal amount of the wraparound note is $1,000,000 and the interest rate on the note is 12 percent, the balance on the seller's existing underlying third-party debt is $500,000 bearing interest at 6% per annum, and the maturity of the wraparound loan equals the remaining maturity of the underlying debt. Under these circumstances, the interest rate on the new debt portion of the wraparound note is 9 percent, and this is the rate that should be subject to the test rate. Either an institutional third-party lender who deals in wraparound financing or a seller would provide the additional lending over the balance of the existing debt in this manner.

In addition, it is ludicrous to impose restrictions which penalize sellers for retaining and passing on to buyers the benefits of long-term financing previously bargained for when the existing financing was undertaken. Such restrictions greatly discourage assumptions and wraparound and inflate the cost of real estate (by increasing debt service) for the sole benefit of underlying third-party lenders. Such provisions also unfairly penalize borrowers under long-term financing where there is a prohibition against or penalty for prepayment. Such sellers would be deprived of the benefit of using the debt for an assumption or wraparound loan at an interest rate lower than current market rates, but would continue to suffer the detriment of bearing the risk that they will be locked-in to long-term market rates if interest rates decline.

E. Mismatch Prevention

As we discussed above, we support changes intended to stop the mismatching of income and deductions of taxpayers with different accounting periods. We believe that requiring cash basis accounting for smaller transactions and accrual accounting for larger transactions is a reasonable approach. However, we believe a better solution would be to require both the buyer and seller to use their existing accounting method if they are the same, and require both the buyer and seller to use cash accounting in smaller transactions and acrual accounting in larger transactions.

F. Problems Associated With Imputation of Interest

1. Capital Losses on Investment Assets

The "new rules" fail to consider the great inequity which would result to sellers of "investment assets" if interest payments above contract amounts are imputed. Some farmers and other sellers of non-productive investment assets (§1221 capital assets) whose property values have decreased might have non-deductible net capital losses (totally non-deductible for corporate sellers and non-deductible over $3,000 per year for non-corporate sellers).

The imputation of higher than contracted rates to such transactions would increase the non-deductible net capital losses of the sellers by recasting a lower sale price while increasing the taxable interest income without actual increases in income of the seller already suffering from his capital loss.

This inequity should be resolved either by:

1) Providing for no imputation if it would create or increase a capital loss on investment assets; or

2) Providing that net capital losses will be treated as net §1231 losses, or as other ordinary loss deductions, to the extent of any capital loss resulting from sale price recasting due to imputed interest.

2. Imputed Interest Deductibility

Treasury has stated its intent to avoid mismatching, i.e., to have equality of interest income and deductions, between the buyer and seller. However, the application of the existing "investment interest" limitations might destroy such equality by disallowing a portion of buyer's interest payment as a current deduction.

This inequality should not be accentuated by the imputation of additional interest expense to the buyer who may not deduct it. Imputed interest should be currently deductible by the buyer regardless of existing investment interest limitations.

Similarly, Congress should repeal Section 1275(b), which would limit imputed interest deductions related to the purchase of personal-use property.

3. Imputation Rate

The imputation rate should be the same as the test rate because the rules are likely to be complex enough to constitute a trap for the unwary, because it is questionable whether exceeding any test rate indicates anything about either tax motivation or tax impact, and because this will bias financing away from sellers and toward institutional lenders.

G. Revenues

Revenue estimates for the new rules have been published. However, it is our understanding that these are based on the output of static econometric models that ignore the likely consequent reduction in transaction activity and in capital gains taxes paid caused by the new rules. In times of high interest rates, meeting the 110 percent of AFR test rate would increase debt service costs in most transactions to the point that rents would not carry them. Sales would not occur in this situation.

We believe that, rather than a revenue increase resulting from the curbing of abuses by the new rules, there would be significant revenue reductions as legitimate transactions are deterred and capital gains tax receipts are reduced.

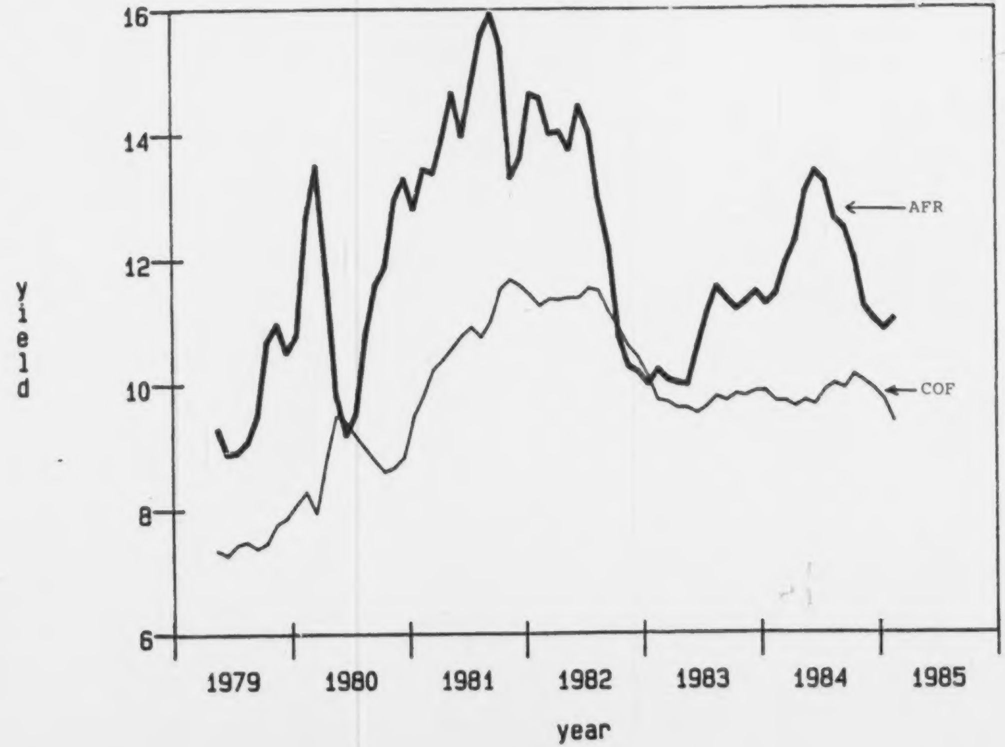
We further believe that it is improper to invoke the principle of revenue neutrality in a situation where the calculated revenue gain is due to a flawed analysis. The fact is that the new rules will prohibit many legitimate transactions.

V. CONCLUSION

The ICSC believes that the new OID and imputed interest rules must be substantially amended if they are to meet their objective of curbing potential abusive deferred sales transactions without interfering with the use of seller financing as a valid method of financing real property sales in times of high interest rates. Specifically, changes are needed to remedy problems with the index used for the test rate, with the level of the test rate, with the treatment of variable and contingent rate loans and loan assumptions and wraparounds, with the treatment of capital losses on investment properties, and with the treatment of buyers' imputed interest deductions.

GRAPH 1

APPLICABLE FEDERAL RATE, MID-TERM MATURITY
(U.S. TREASURY 3-9 YR. MATURITY) (bold);
AND FHLBB COST OF FUNDS (line)



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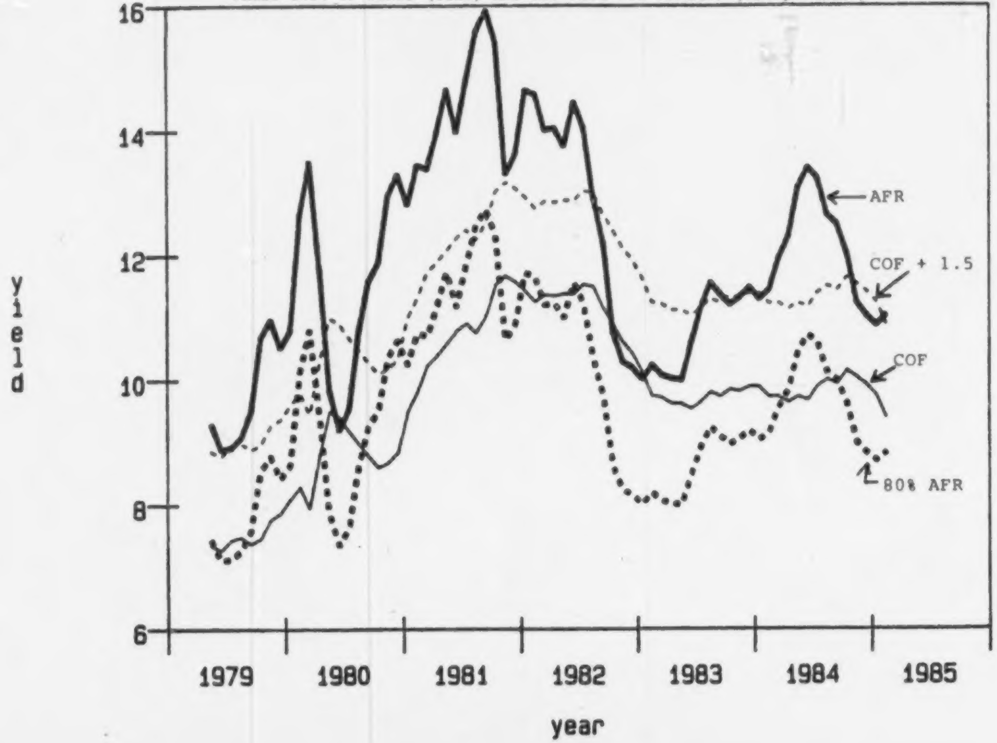
GRAPH 2

100 PERCENT (bold) AND 80 PERCENT (bold, dotted) OF THE
APPLICABLE FEDERAL RATE, MID-TERM MATURITY
(U.S. TREASURY 3-9 YR. MATURITY) AND
FHLBB COST OF FUNDS (line) AND COF PLUS 1.5 PERCENT (line, dotted)



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STATEMENT OF STEPHEN DRIESLER, EXECUTIVE VICE CHAIRMAN, NATIONAL MULTI HOUSING COUNCIL, WASHINGTON, DC

Mr. DRIESLER. Thank you, Mr. Chairman. My name is Stephen Driesler. I am the executive vice president of the Multi Housing Council. The disadvantage of going last in a hearing such as this is that all the witnesses before you have already made the points that you have included in your testimony. So, I would like to ask that my testimony be put into the record at this time, and I would like to spend the rest of my time summing up and trying to, I guess, make a closing statement of the industry point of view of what this issue is really all about.

Mr. Chairman, I have followed with great interest your line of questioning, starting with Mr. Pearlman and going through the last panel of witnesses, and you have really hit all around what I consider to be—and I think what the industry considers to be—the nut of the issue. And let me try, if you will, walk you through the example that the Joint Committee and Mr. Pearlman referred to in the Treasury testimony. And that is: What are these rules all about? The rules are about preventing abusive situations—abusive transactions.

Mr. Chairman, you asked Mr. Wechsler on the former panel how do you structure a deal or a transaction or rules so that sophisticated buyers and sellers cannot avoid paying their fair share of taxes. That is a legitimate question, and that, Mr. Chairman, is what this discussion should be all about, not the size of the transaction; $2 million is a big transaction where I come from, too, and 10 $2 million transactions can be just as abusive as 1 $20 million transaction, depending upon the way the transactions are structured.

Now, let me walk you through the example and show you how you can limit the abuse without subjecting legitimate transactions to these complex and costly rules. If you will refer to the Joint Committee's pamphlet on page 15, or the Treasury's testimony on page 14, they talk about a transaction of $100 million at 13.5 percent, for 18 years. Now, the 18 years is very critical, but the most important factor is that they assume that 100 percent of the sales price—the $100 million—is seller financed. And if you go through their conclusions on page 16, this leads to an overstatement of basis of one-third roughly—$33 million.

Now, if you take that same transaction, Mr. Chairman, and only finance 50 percent with seller financing, the overstatement of basis goes down—it is cut in half. There is a one to one relationship, so you are down to—what?—16 percent overstatement of basis. If you cut the percentage of the purchase price down to 25 percent seller financing, you cut the potential over statement of basis down one-fourth, as well. Now you are down to somewhere in the neighborhood of 8 percent overstatement, according to the Treasury and the Joint Committee's own figures. Everything else being equal, even using 18-year term. Now, Mr. Chairman, I will submit to you that if you take three appraisers and go out and appraise a $100 million office building or a $100 million apartment building, there will be more than 8 percent variation between the high and the low appraisal—legitimate appraisals, competent appraisals. Now, what is the true market value?

The simple fact is, Mr. Chairman, there is a range of values in which that building falls. It is not like a stock or a bond where you can pick up the Wall Street Journal and find out to the nearest one-eighth of a dollar what the price sold for yesterday. These are unique properties, and their values do vary within a range, and that range could vary up to 10 or 12 percent. That is not tax abuse. That is simply what three or four honest, legitimate appraisals would vary. So, what you do is you structure a rule that gets you to a point within that margin of error. You take the term of the seller financing, less than two-thirds of the ACRS life, you take less than half of the building is seller financed. You make the parties pay at least 80 percent of the interest, currently, and Mr. Chairman, when you put those factors into it and you have matching accounting on both sides, you have compounding interest, there is simply no potential for abuse. And if there is no potential for abuse, these stringent roles of 110 percent of the AFR ought not to apply. Apply a more stringent feet for transactions that fall into the potentially abusive category. I don't think anybody around this table would be upset with that, but for the nonpotentially abusive, apply a more reasonable test rate. We believe a more reasonable test rate is something around the 9 percent or the 80 percent AFR as included in much of the legislation now before this committee. Thank you, Mr. Chairman.

[Mr. Driesler's prepared statement follows:]

STATEMENT OF
STEPHEN D. DRIESLER
ON BEHALF OF THE
NATIONAL MULTI HOUSING COUNCIL
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE,
CONCERNING THE TAX TREATMENT OF IMPUTED INTEREST

Mr. Chairman and Members of the Subcommittee, my name is Stephen Driesler, and I am the Executive Vice President of the National Multi Housing Council. The National Multi Housing Council is a nationwide organization of over 6,000 members, representing all aspects of the rental housing industry. Together, NMHC members own or operate hundreds of thousands of rental housing units.

The National Multi Housing Council is grateful to the Finance Committee for addressing the difficult issue of imputed interest so promptly, in order that permanent relief legislation can be enacted before the expiration of last year's stopgap provisions on July 1, 1985. Seller financing is often essential for the purchase of rental housing because of the relatively substantial sums of money which are involved in such transactions. Accordingly, the 1984 legislation impacts very severely on developers and owners of rental housing and on the potential market for such assets.

Even with the stopgap legislation enacted last October, the Deficit Reduction Act of 1984 now requires that purchase-money financing for all but the most modest of apartment buildings state an interest rate of no less than 110% of the so-called "applicable Federal rate" ("AFR") in order to avoid the imputation of interest at 120% of the AFR. If the stated interest payments are not deemed "adequate" under this statute, or if interest payments are not required to be made currently, taxable interest income will be charged to the seller under a complex formula which allocates the difference between the deemed purchase price (after its adjustment for imputed interest) and the total deferred payment amount into daily portions which must be aggregated for each taxable period. In addition, when interest is imputed, payments from the buyer which were intended to represent the purchase price are recharacterized as interest, thereby reducing the buyer's cost basis in the property.

Clearly, these rules are complex and require extensive computations. However, perhaps the most significant adverse impacts on the rental housing industry from these provisions result from their inflexibility. During recent periods of high interest rates, buyers and sellers of rental housing were forced to devise alternative methods for financing these transactions because outside financing was unaffordable. For example, it was not uncommon for sellers to state a low interest rate at sale because the present income from the property could not support additional debt service. However, the seller would also take a percentage of the increase in rental income and/or a portion of the proceeds from refinancing or sale as additional interest.

There are a large variety of ways in which such transactions can be structured. Common variations include a minimum, stated interest charge, whether or not paid currently, and an additional, contingent interest charge, the amount of which is measured by either a percentage of net income or a percentage of net proceeds from refinancing or resale. It is generally not possible to predict with accuracy how much interest will actually be received under such arrangements, even though there is a real expectation that substantial interest will be realized. Further, although not susceptible to calculation at the origination of the loan, such contingent interest is generally sufficient to provide a rate of return at least equal to a commercial rate. These variations, however important as they are to real estate buyers and sellers, do not lend themselves to the rigidities of the deferred payment rules. Accordingly, the Federal income tax treatment of such contingent payments under the permanent deferred payment rules is still unclear almost nine months after their enactment.

The nonrecognition of contingent financing is but one example of how the ability of buyers and sellers to negotiate transfers of property according to the best and most mutually affordable arrangement will be critically encumbered by the rigidity of the Federal income tax consequences. In addition, in some jurisdictions the AFR has exceeded the maximum rate allowable under state usury statutes, and, therefore, compliance with the tax law would be illegal in those places.

Another problem which has already been partially addressed in temporary Treasury regulations is the so-called "time lag" problem with the AFR. As originally drafted, the AFR was to be determined based on comparable term Treasury rates during the preceeding three to fifteen months. In a period of falling interest rates (such as has occurred since enactment of the Deficit Reduction Act), buyers and sellers are required to use above-market interest rates in their transactions or suffer the penalty of having an even higher rate imputed for Federal income tax purposes. The Treasury has now provided for the election of a monthly rate (computed as of the fourteenth day of the preceeding month) in lieu of the semi-annual AFR, which alleviates but does not completely eliminate this problem. A lapse of several weeks can still produce significant variations in interest rates which when compounded over twenty to thirty years in a multi-million dollar real estate transaction is a considerable cost. By the Treasury's own admission, however, use of a more frequent AFR greatly increases the complexity of the interest computations, in effect requiring every taxpayer to renegotiate, according to the daily Wall Street Journal, transactions which may have begun weeks or even months before.

Further, mandating such precise adjustments in interest rates will result in frequent, significant and fallacious fluctuations in the values of all real estate assets. Unlike a Treasury bill or other money market instruments, rental housing has value apart from the mere income stream which it currently produces; it is a durable, physical asset which will outlast many economic cycles. Accordingly, temporary fluctuations in interest rates do not have so substantial and direct an impact on the real values of such assets as would be reflected in the "values" computed under the current deferred payment provisions. These rules effectively adjust the market values of real property for every change in interest rates.

Whereas, the value of a $1 million discount bond with a 10% yield could be reduced by as much as one-third after an interest rate increase of 500 basis points, an apartment building worth $1 million, producing a 10% current cash return, need not lose one-third of its value in similar circumstances. The value of a bond is determined solely according to its yield. The logic of the 1984 imputed interest rules carried to its extreme would treat leveraged real estate as if it, too, were merely a money market instrument. This is neither realistic nor reflective of the market. There is the value of the land; there is the cost of the materials and labor necessary to replace the structure; there is its potential for other uses. Certainly, an empty building is not worth as much as a fully occupied building generating cash flow, but unlike a bond, its value is only partially dependent on the cash it currently throws off.

The ability of sellers to offer flexible purchase-money financing is one mechanism for maintaining stable price levels for real estate and predictability in the real estate markets in periods of unusually high interest rates. Such long-term stability and predictability are essential components of the confidence necessary to induce investors to purchase rental housing, which by its very nature is a long-term investment, permitting the markets therein to operate fairly and effectively.

Finally, under the stopgap legislation, mortgage financing originated after October 16, 1984 and assumed by a purchaser would be subject to readjustment under the deferred payment rules, even though the original financing had adequate stated interest at the time of its creation, the terms and conditions thereof are not altered and the original lender is not a party to the subsequent transfer. The carryover of existing financing is standard practice in real estate transfers. Requiring that such prior financing be readjusted to reflect current interest rates for Federal income tax purposes when the actual payments due to the original lender under the instrument are unchanged produces results which are absurd in practice. For example, theoretically, the original lender whose financing is assumed at a time when interest rates have risen would recognize an immediate bad debt deduction which would be recouped through taxable imputed interest payments (aggregating to the amount of the bad debt deduction) over the remaining loan term. This would afford most lenders substantial current income tax deferral and undoubtedly result in significant losses in Federal revenues.

Because of these problems of complexity, inflexibility and over-sensitivity to interest rates, the National Multi Housing Council believes that significant modifications to the current deferred payment rules are necessary. First, before imposing such complex and inflexible rules as imputed interest and original issue discount on a wide range of transactions, this Committee should carefully reconsider what it is trying to achieve and craft legislation which deals with potential abuses but does not interfere with ordinary, non-abusive seller financing. According to the Treasury Department, there are three areas of potential abuse:

1. Mismatching of income and deductions. Mismatching occurs when the buyer and seller use different methods of accounting, allowing tax deductions to be taken by one party without corresponding income recognition by the other. This problem, however, can be easily solved by requiring both buyer and seller to use the same method of accounting for each transaction. The National Multi Housing Council further urges this Committee to allow the option of either cash-cash or accrual-accrual accounting since either approach solves the mismatching problem without significant revenue implications to the Treasury.

2. Artificial accrual of interest. Various methods of calculating interest distort the interest component in real estate transitions. The rule of 78s overstates interest in the early years, and simple interest understates it in the later

years. The use of compound interest is a more appropriate method of determining interest, and the National Multi Housing Council supports this change in the law.

3. Overvaluation. The last and only remaining potential abuse is the use of interest rates that are excessively low over a long period. This can significantly increase the buyer's cost basis in the property and understate the portion of the purchase price which should be taxed to the seller as interest income (ordinary income) in lieu of capital gains.

Very few seller-financed transactions now fall into this third category. Therefore, if made available for all transactions where seller financing represents no more than one-half of the purchase price, where its term is no longer than two-thirds of the asset's depreciable life and where at least 80 percent of the interest is paid currently, use of the 9% test rate of prior law would not significantly distort either property values or Federal income tax liability. Why should such a transaction, even if it were for $10 million, be subject to these complex and inflexible original issue discount and imputed interest rules? We submit that it should not be.

Accordingly, the National Multi Housing Council recommends that this Committee expand the category of transactions entitled to the 9% test rate now in the interim rules and include non-abusive transactions regardless of their size Non-abusive transactions would be defined to include all transfers with seller-financing which 1) do not exceed one-half of the purchase price. 2) have a term no longer than two-thirds of the asset's depreciable life and 3) at least 80 percent of the stated interest is paid currently. At the present time, the National Multi Housing Council believes the transaction costs of complying with these very complex and difficult provisions will outweigh any revenue savings to the Treasury from their use.

Second, any assumed financing which had adequate stated interest at the time of its creation should not again be subject to adjustment under the deferred payment provisions. Accordingly, so long as the terms and the conditions thereof are not materially altered, assumptions of financing which did not entail original issue discount should not become discount obligations for Federal tax purposes because of subsequent events. H.R. 2475 reported by the House Committee on Ways and Means on May 17, 1985, exempts all assumptions from these rules, and we urge the Finance Committee to do likewise.

Third, a more stable index than the AFR should be used to measure the adequacy of interest on purchase money financing. The AFR represents the price that the Treasury must pay to borrow in the money markets on an essentially involuntary basis. Because the timing of such Treasury borrowing is not discretionary, it pays rates which will fluctuate widely according to external events which influence professional investors and speculators. One alternative would be to use the Federal Home Loan Bank Board's "cost of funds" index which is a weighted average of the cost paid by savings institutions (which are significant mortgage lenders) for their own capital. This index is far more relevant to real estate financing than the AFR because it represents the lender's own cost of mortgage money. Most importantly for the rental housing industry, however, is the fact that the cost of funds rate has been far less volatile than Treasury borrowing rates on both the upside and the downside. (See Exhibit A for a chart comparing the cost of funds index with the AFR.) Therefore, its use would lend necessary and desirable stability to the real estate markets.

Whatever index is used -- be it AFR, cost of funds or some alternative -- the test rate must be set at a level which is realistic based on historical trends in real estate financing and which permits transactions to continue during temporary periods of high interest rates. For example, the use of 80% of the AFR, which has been proposed by numerous members of Congress, is a much more realistic measure than the 100% of AFR which would be required under the terms of H.R. 2475, as reported by the House Ways and Means Committee.

If this Committee should decide to use a test rate of 100% of the AFR (or greater) the National Multi Housing Council strongly urges the adoption of some form of governor or cap to ensure that seller financing remains a viable option in times of atypically high interest rates such as we saw in the late 1970's and early 1980's. During such periods of unusually high interest rates real estate transactions would virtually cease if sellers could not offer rates significantly lower than commercial lenders.

Brief abberations in the historical level of interest rates for real estate financing should not be allowed to disrupt all sales activity, particularly when both the buyer and seller realize that interest rates will return to more normal levels in the not too distant future. To bind seller financing to every temporary fluctuation in interest rates would have a disproportionate impact on the values of long-term, tangible assets, such as rental housing, and would cause more severe and lasting economic distortions than those to which the deferred payment provisions were originally addressed.

Finally, H.R. 2475, as reported by the House Ways and Means Committee permits use of a 9 percent rate for seller financing for transactions where the sales price does not exceed $2 million. However, the House bill phases out the benefits of this lower rate, completely eliminating them for transactions in excess of $4 million. The National Multi Housing Council believes that the benefit of the reduced rate on the first $2 million of seller financing should not be limited to small transactions. All buyers and sellers should have option of applying the 9 percent rate to the first $2 million of seller financing to prevent an unequal distribution of tax burdens which will unfairly penalize investors in larger properties, however modest individually, merely because of the size and value of the aggregate investment.

The National Multi Housing Council recognizes the goal of revising the income tax rules regarding deferred payment transactions without revenue cost to the Treasury. However, the National Multi Housing Council believes that, under current economic conditions with reduced and falling interest rates, the revenue gains to be expected from application of these complex provisions are minimal and, further, that equivalent revenues could be obtained under prior law by simply requiring the use of compound interest and matching accounting methods for all non-abusive transactions. However, should the Committee determine that additional revenue is needed, fairness dictates that the burden of any such increase fall only on those actually making use of seller-financing, rather than on the entire real estate industry.

Senator **Chafee**. Your definition of the nonpotentially abusive—are you going to use the same definition that some of the others have used?

Mr. **Driesler**. Yes, sir; I believe we pretty much agree on what the parameters are of abusive transactions, or potentially abusive transactions.

Senator **Chafee**. Mr. Szymanski had a definition. Why don't you come up with your definition now of potentially abusive? It has to be a long enough period—is that right?

Mr. **Szymanski**. Yes, it would have to exceed two-thirds of the ACRS life. It would have to be seller financing more than 12 years.

Senator **Chafee**. All right. That is one factor. What about the others?

Mr. **Szymanski**. OK, and the interest paid would have to be less than 80 percent to be an abusive transaction.

Senator **Chafee**. Less than 80 percent of the——

Mr. **Szymanski**. Applicable Federal rate.

Senator **Chafee**. All right. Now, let's assume that you arrive at the conclusion that it is abusive. Then what happens?

Mr. **Szymanski**. Then, if it is an abusive transaction, then I think in that situation a different test rate should apply versus the lower test rate for a transaction that is potentially not an abusive transaction through these three tests.

Senator **Chafee**. I mean, for example, what would you have—100 percent?

Mr. **Szymanski**. You could have it at 100 percent of the AFR rate.

Senator **Chafee**. Let me ask this question of Mr. Driesler. Using that definition that we have just agreed on for abusive, can you give us an estimate of what percentage of seller financed agreements would meet the abusive test?

Mr. **Driesler**. I have no basis upon which to give you any. My knowledge is that most seller financing is less than 10 years. Most seller financing that I am familiar with with involves less than 50 percent of the purchase price. Most of it involves a substantial portion of interest paid currently—say 75 percent or more of the interest is paid currently. So, the transactions with my members that I am familiar with, I would say very few would fall into the abusive category, but overall I would have no way of answering that honestly.

Senator **Chafee**. What about the rest of you gentlemen? First of all, I am surprised that the seller financing is in most instances less than 50 percent?

Mr. **Driesler**. Yes, sir. I would say most—I did a poll of my board members last week, and in fact most of it was less than one-third, quite honestly. Most of them are 20 to 30 percent of the purchase price.

Senator **Chafee**. What do the rest of you gentlemen say?

Mr. **Driesler**. And the same thing would apply to the International Council of Shopping Center members also.

Mr. **Szymanski**. Mr. Chairman, our firm is a brokerage firm. It is commercial-industrial real estate, so we are, I guess you would say, in the middle of this quite frequently because we are brokers and we deal in this type of property. I agree very much. The incidence of seller financing being 100 percent is virtually nonexistent.

Senator CHAFEE. How about above 50 though?

Mr. SZYMANSKI. Below 50 is the predominant——

Senator CHAFEE. Above 50.

Mr. SZYMANSKI. Above 50? Very few. Very few, and very few of the——

Senator CHAFEE. Of course, you people are the big hitters of the industry here. You are the big operators. If we were talking about residences, would it be larger?

Mr. DRIESLER. That would be smaller.

Senator CHAFEE. You think it would be smaller?

Mr. DRIESLER. Probably, but you would have to ask one of these people who represent that portion.

Senator CHAFEE. Mr. Schneier, what do you say to all of this?

Mr. SCHNEIER. From the small business perspective, I suppose it would probably be less than 50 percent as well. A certain amount of cash will change hands in the transaction up front and the rest would definitely be less than half, although I have no real basis for it.

Senator CHAFEE. All right. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman. Mr. Szymanski, you made the comment about revenue loss. The question I would like to ask each of you is if in fact the current rules, as a result of the 1984 act, are negative on transactions, isn't that a bigger revenue loss to the Treasury? Would a revision on the order of either going back to the pre-1984 law or going back to the recommendations of either the House or Senator Durenberger or Senator Melcher allow more transactions and therefore more revenue for the Treasury? How is that going to work?

Mr. SZYMANSKI. I think that is absolutely true. Under the law—under the 1984 act—you are going to have less transactions and therefore less amounts of capital gains reported, and therefore less tax paid on capital gains. Therefore, under a more reasonable rule, I think, you are going to want to have more transactions taking place, more capital gains reported, and more capital gains taxes paid.

Senator SYMMS. Mr. Driesler.

Mr. DRIESLER. My feeling is identical to Mr. Szymanski's. I am not a revenue estimator, but based upon that, it clearly is going to reduce the number of transactions to the extent those transactions produce revenue from capital gains or interest income—then, you are going to have less. I think the big point is that I would like—and Senator Chafee hit on this earlier—we happen to believe that it is also grossly unfair to make the people who do not use seller financing pay for any benefits that accrue to those who do use seller financing since, again, most of the people in my business do not use seller financing as the main form of doing a transaction. But, that doesn't totally respond to your question and the response is that our best estimate is this legislation—the 1984 act—is going to reduce revenue to the Treasury rather than enhance it.

Senator SYMMS. Mr. Feldewert.

Mr. FELDEWERT. From practical experience of having gone through several periods of high interest rates during the last 15 years, this rule, if implemented to the extent that it is now proposed, would effectively shut down a great deal of commercial-industrial transactions if we return to the high interest rates that we experienced in 1981 and 1982.

Senator SYMMS. So, then there would be a clearly negative transaction tax that would affect the Treasury if you didn't have the transactions?

Mr. FELDEWERT. Without a doubt because the other thing that I think we must remember is everyone talks about the impact of converting the interest income to capital gains on the seller, but unless the rules have changed dramatically, and I don't think they have—and I am an old CPA—I know that if there is an interest income factor on one side, there is an interest deduction on the other side. So, it is true that if you cut down the interest income of the seller, we should also remember that you are cutting down the deduction for the buyer. And unless there is a very significant tax rate—I'm sorry—tax rate differential between these two, it seemingly to me, at least, would be a relatively negligible impact on Treasury income.

Senator CHAFEE. Yes, but don't forget that then there is an inflated price under the illustration you gave and thus greater deductions by the purchaser.

Mr. FELDEWERT. But, Senator, with all due respect, one, that deduction is spread out over 19 years. Two, to the extent that the interest is disallowed, you are now denying a current deduction, or the interest is put into basis. We are taking what would be an ordinary deduction today and spreading it out over 19 years, or 18 years, or 15 years, or whatever the period happens to be. So, I think that impact is greatly overstated.

Mr. SCHNEIER. Senator, clearly if you inhibit the ability of seller-financed transactions to small businesses, you are going to have liquidations of small businesses and the resulting loss of jobs in certain areas. It may be more severe in others, depending on the numbers of small businesses in a particular area. Our members are very concerned about that.

Senator SYMMS. Thank you very much, gentlemen, and I want to thank all the witnesses, Mr. Chairman, and thank you and Chairman Packwood for holding this hearing. I think it has been very enlightening and I appreciate that we have had it.

Senator CHAFEE. Gentlemen, you seem to differ a little bit from the prior panel. I guess it was Mr. Szymanski who said or implied that there is an intrinsic value to real estate. Real estate does not respond to changes in interest rates in the predictable fashion. I don't know what you mean by "predictable," but if interest rates are higher, presumably you can't sell your real estate for so much. Is that true?

Mr. SZYMANSKI. Short-term fluctuations in Federal interest rates really do have relatively little impact because in real estate you have a relatively long-lived asset. You are looking at long periods of time. Say, for example, in the real estate business if the Federal interest rate happens to be, say, 15 or 16 percent, a real estate transaction would not go forward. If you pencil out the transaction to determine whether the project can carry that kind of debt, and in most cases, the rents obtainable from the property would be in-sufficient to pay the debt service. So, therefore, the developer in that situation would just not go forward or not buy the property. And therefore, the developer can wait until interest rates come down, where the Federal Government is not in the same situation. When the Federal Government needs money, they go out and issue Treasury bills or whatever. They are not in the same arena. A real estate transaction would stop dead in the tracks because of the fact that, if it works out where, based on a pro forma projection, you couldn't afford the debt service, a project wouldn't go forward. It would just stop.

Senator **Chafee**. All I am trying to say here is that it seems to me that the value of real estate does vary depending upon the interest rate. You can get more money for your real estate when interest rates are low than you can when they are high. That was the trouble with the high rates, wasn't it? When we went through all those troubles 7 or 8 years ago, it was just that the interest rates were so high, the value of the property dropped. That is what is happening with farmland now to a considerable extent West, isn't it?

Mr. **Szymanski**. Yes. Real estate is a very complex asset, and interest rates are one factor, but also it is the location, the degree that you can pass the rents on to tenants, or it is an office building or a shopping center, but there are all these other factors. We look at the three key things in real estate as location, location, and location. and not interest rates.

Mr. **Driesler**. Mr. Chairman, I think you are right to an extent. Let me point out why I say to an extent. If you have a discount bond today that is yielding 10 percent and for some reason market interest rates—however you determine them—tomorrow shoot up 300 basis points, the value of that bond is cut by a third. It is a direct one-to-one relationship. If you have a building—an office building or apartment building—today and interest rates shot up the same 300 basis points, the value of that building does not go down a third. It does decrease, but it does not go down a third. And that is the fallacy underlying this whole analysis which treats real estate like a bond. The cost of replacement of that building, what it would take if somebody else had to go out and take the bricks and the mortar and the labor to build the building over again, and the value of any building is not going to fall below its replacement cost. Now, it may fall, but there are limits to where it will fall, and it does not fall in a direct one-to-one relationship like a bond.

Senator **Chafee**. Yes, except that you have all agreed that we should use a figure of 80 percent of the applicable Federal rate. Now, we are arguing about how much, but you have used the same basis of a bond.

Mr. **Driesler**. If you will look at my testimony, and I think most of the testimony of the people here, we do not think it should be tied to the applicable Federal rate, but I guess we are reluctantly accepting the fact that it is going to be tied to the applicable Federal rate. It is going to be rough justice, and we say that 80 percent is a more just figure than 100 or 110 percent, but it is rough justice at best.

Senator **Chafee**. I guess that is what we are dealing with.

Mr. **Feldewert**. Mr. Chairman, if I might just add for the moment? Now, let's go back to earlier this morning. You stated, or you made the remark about interest rates of 19 percent, as they were at one time. There is no commercial transaction that could effectively be carried out with a 19-percent interest rate during any period that I have been in the business—80 percent of that would still produce a 16-percent rate. What we are concerned about is the impact of this rule—not today when the Federal funds rates are 12 percent, but when those rates become 20 percent, we are concerned that the rules will effectively prohibit transactions at that time—not today. As Mr. Waliop said earlier, and you remarked earlier: These are good times. But the times may very well return when interest rates are 18 and 20 percent, and if you have the forced rate, which is the only way I know to call this thing, the forced rate at 18 and 20 percent—you have effectively shut down the market.

Senator **Chafee**. Thank you very much for coming, gentlemen. We appreciate it.

Mr. **Feldewert**. Thank you.

Mr. **Driesler**. Thank you.

Mr. **Szymanski**. Thank you.

[Whereupon, at 11:15 a.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF SENATOR JOHN W. WARNER
BEFORE THE SENATE FINANCE COMMITTEE
May 20, 1985

Imputed Interest Rules for Seller-Financed Property Transactions

Mr. Chairman,

As a participant in the discussions last fall to revise the imputed interest provisions of the Deficit Reduction Act of 1984, I wish to commend the Senate Finance Committee for considering this very important issue in such a timely manner.

On July 1 of this year, the arduously negotiated compromise reached last fall will lapse.

Unless Congress acts, the provisions of the 1984 act, which a majority of both houses of Congress found so onerous, will once again become law.

This cannot be allowed.

The fact that the committee has before it five different proposals, one of which I am a cosponsor along with the distinguished Majority Leader, indicates to me the seriousness of this matter in the minds of a majority in Congress and the majority of Americans.

I urge the committee to act in a reasonable and expeditious manner.

Too often in recent years, in our efforts to improve taxpayer compliance and reduce the incidents of tax code abuse, the Congress and the Treasury have made decisions which prove counterproductive and harmful to the objective of improved voluntary compliance.

By consideration of the measures before the committee today, and by congressional consideration of other similar initiatives--the contemporaneous recordkeeping legislation repealed by the Congress last week, and the interest withholding provisions repealed by the Congress two years ago--I am hopeful that we are learning a valuable lesson which will carry over into the debate on tax reform.

Taxpayer compliance is a serious and expensive problem for the federal government. This committee and the Internal Revenue Service estimate that in this fiscal year the government will lose $90 billion to $150 billion as a result of deliberate or accidental decisions on the part of taxpayers to either under-report or fail to report their legally-owed taxes.

It is easy for the government to point at these people and say theirs is a blatant attempt to cheat on their legal responsibility.. But the simple fact of the matter is that our current tax laws, and the method by which they are administered, contribute significantly to the problem.

Because of the complexity of the code, and its perceived unfairness--in part fostered by such provisions as imputed interest as passed in the '84 Deficit Reduction Act--the tax gap is widening and the spirit of voluntary compliance is waning.

According to a recent IRS survey, 75 percent of taxpayers believe their taxes are too high for what they get in return.

About two-thirds believe they pay more than their fair share.

Even worse, a whopping 80 percent of the taxpayers believe the present system benefits the rich and is unfair to the ordinary working man and woman--like the middle class homeowner trying desperately to sell his home; having to use owner financing to do it because market rates are too high for anyone interested in the property to buy it without help from the seller.

But what is this homeowner to do? What is he to think, especially if Congress does not take steps to make permanent the solution to the imputed interest issue which was adopted last October.

Especially, if Congress does not remember that the overwhelming majority of Americans are willing to do their part, but they want to participate on a fair and equitable basis.

If they feel something is being jammed down their throats, and that no reasonable avenue of redress is available, then they will stop volunteering.

The amount of unpaid taxes will grow, and all the tax agents in the world will have little affect on improving taxpayer compliance.

That is contrary to the principles of our democracy and our judicial/legal system.

That is a path this Senator cares not to travel.

THE CONTINUING CARE COALITION

PROPOSED AMENDMENT TO INTEREST-FREE LOAN RULES FOR ENTRY FEES TO CONTINUING CARE COMMUNITIES

1

On May 20, 1985, the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance held hearings on several bills to amend the imputed interest provisions added to the Internal Revenue Code in the Tax Reform Act of 1984. The Continuing Care Coalition has prepared this statement in connection with that hearing and respectfully requests that it be included in the record of the proceedings for that day.

The Continuing Care Coalition submits this statement in support of legislation that would prevent creation of an imputed interest tax liablity under the "below market interest rate loan" provisions of Section 7872 of the Code on certain entry fees paid by elderly residents seeking continuing care services. This legislation, which is estimated to have a de minimis revenue effect and is likely to result in a reduction in federal health care expenditures, will insulate elderly persons seeking lifecare services from taxes that would otherwise be imposed on income that is never received. At the same time, this legislation will make lifecare services more readily available to America's rapidly increasing elderly population.

The Continuing Care Coalition

The Coalition is comprised of a number of associations representing the interests of the elderly and of other persons concerned with the proper care and treatment of the elderly. The coalition is uniquely situated to comment on the proposed legislation since it represents for-profit and nonprofit providers of continuing care services and consumers of such services. Specifically, the Coalition includes: (1) The American Association of Homes for the Aging; (2) The American Association of Retired Persons; (3) The National Association of Retired Federal Employees; (4) The Retired Officers Association; (5) The Life Care Council; (6) The Marriott Corporation.

The Continuing Care Concept

Continuing care communities (which are also referred to as lifecare communities) have been described as residential facilities which provide long-term housing accommodations, health care and other supportive service to people of retirement age. This definition, however, inadequately describes the essence of continuing care. Under the typical lifecare contract, in exchange for an entrance payment and a monthly service fee, elderly residents (who's average age is 80 years) are assured a home in the community as long as they wish. Further, residents are assured that, if and when it becomes necessary, adequate nursing care and other supportive services will be provided at little or no additional cost beyond the regular monthly fee. Thus, elderly persons living on fixed incomes are guaranteed that, no matter how rapidly they become infirm, they will be provided with the services they need to enjoy the final years of their lives and to live with dignity. The cost to the elderly individual of health care -- ranging from occasional medical attention for residents in good health to full-time nursing care for the infirm -- is kept low by spreading the risk among all those who reside in the community.

Continuing Care communities offer services that permit older persons to live active, independent lives for as long as they are able, while assuring that their needs for health care services will be provided, if it becomes necessary, and as long as necessary. For example, elderly persons who wish to remain independent may prepare their own meals in their own apartments; those who cannot provide for their own needs, can take advantage of meals prepared in communal dining facilities. Health care services are also provided according to each individual's own needs. Thus, elderly persons who are in good health have only occasional contact with the community's medical staff. Persons who are in failing health, but not yet infirm, have access to a trained nursing staff. If, over time, such individuals become infirm, they can move into the nursing facility.

Typical Fee Arrangements

As previously stated, elderly persons entering a continuing care community pay an entry fee and a monthly service fee. In many cases, the entry fees are funded from the proceeds of the sale of a residence and can reasonably be viewed as a continuation of a taxpayer's investment in living accommodations.

Traditionally, entry fees were refundable only during an initial trial period, with the fee reverting back to the facility at a rate of generally two percent per month over a period of 50 months, resulting in no remaining balance to be refunded. Communities developed later turned to fee arrangements in which a portion of the entry fee remains refundable as a longer-term investment protection, should they find the community inappropriate or objectionable. More recently, communities are being developed with entry fees that remain fully refundable during the entire period of residence, and are returned to the resident if they choose to leave, or to their estate upon death.

Section 7872 Rules

Section 7872 of the Code, which was enacted as part of the Tax Reform Act of 1984, describes the circumstances under which interest free and below-market interest rate loans may create a tax liability. Further, this section specifies that any transfer of money that creates an obligation to repay a debt may be considered a "loan" for federal income tax purposes. The individual transferring or paying the fees would be treated as a "lender" and would be required to recognize interest income on the fees, even though no interest payments were actually received. This "income" would be subject to taxation as if it had actually earned interest at an applicable federal borrowing rate.

The Senate Finance Committee report on Section 7872 states that most non-abusive transactions are not affected by the bill. This section was intended to clarify tax treatment of interest-free loans between family members and other loan transactions designed to avoid full taxation of income. As it became apparent that entry fees paid to continuing care facilities would be affected by this section, Congress sought to correct this problem in the Conference Committee deliberations. When this was found to be inadequate, a subsequent floor colloquy was offered during the final days of the legislative session by Senators Dole, Heinz and Chiles to again clarify the issue. The issue still remains unresolved. Nonetheless, entry fees paid by elderly persons seeking services -- obviously non-abusive transactions -- could still be subject to the new rules.

Application of Section 7872 Rules to Entry Fees will have a Significant Effect on Continuing Care

If entry fees are treated as interest-free loans, the elderly resident of the continuing care community will be required to pay federal income tax on income they never receive. If this situation occurs, many elderly individuals will be reluctant to enter continuing care arrangements, thus seriously affecting the financial viability of existing facilities and making it extremely difficult to plan and market new faciilties.

As a result, its attractiveness to a wide range of people will decrease, fewer continuing care communities will be developed, and the cost will increase. Further, if an elderly person seeking continuing care services is fortunate enough to find such services, that person will be forced to choose between paying taxes on unrealized income or paying a non-refundable, irrevocable advance payment for such services.

Proposed Legislation

The Coalition strongly urges the Congress to adopt legislation that would provide protection for the existing industry while allowing for future development of these facilities. Specifically, the amendment provides an exemption for facilities in existence or under development as of June 6, 1984, and for those fee arrangements which are clearly not loans. It would also provide an exemption from the imputed interest rules for the first $125,000 of an entry fee paid to a continuing care community. The provision is modeled after Section 121 of the Internal Revenue Code which provides a one-time exclusion from income tax for up to $125,000 of gain from the sale of a principal residence by an individual who has attained age 55.

The Coalition estimates that the proposed legislation will have a de minimis revenue effect. In addition, it is widely believed that since continuing care emphasizes home health care and preventive medicine, increased availability of continuing care services ultimately will result in reduced federal health care expenditures.

Reasons for Proposed Legislation

The Coalition believes that for the following reasons, Congress must enact the proposed legislation.

1. The 1984 Act provisions penalize important, innovative programs that the federal government should encourage. Continuing care is widely viewed as a significant tool for improving the nation's system of providing health care and other services for the elderly. If the 1984 Act provisions apply, continuing care will be more costly and less readily available. The Coalition submits that this is too high a price to pay for tax purity, especially where only de minimis amounts of revenue are involved.

2. The 1984 Act provisions penalize programs that significantly enhance the lives of the elderly. Lifecare provides an elderly person an opportunity to retain the sense of dignity that comes from maintaining one's independence. Further, continuing care provides elderly persons with a sense of security that comes from knowing that their care is assured for as long as it is needed. Most importantly, continuing care provides elderly persons with assurance that health care will be available, and that they will not be forced to "spend down" their assets and become dependent on Medicaid, even if they quickly become infirm, and require a significant amount of care for an extended period.

3. The 1984 Act provisions penalize non-abusive transactions. The payment of entry fees by an elderly person to a continuing care community is not a "tax-motivated" or "abusive" transaction of the kind referred to in the Finance Committee report on the 1984 Act provision. Any tax benefit that may be derived from entry fee payment plan is incidental when viewed in the light of the nature of the services continuing care communities provide. Since the proposed legislation limits to $125,000 the amount of an entry fee excluded from Section 7872, it will encourage development of continuing care arrangements that will be more affordable to a broader segment of America's elderly.

4. There is strong precedent for the proposed legislation. Congress has always recognized the need to balance pure tax policy considerations and other considerations when drafting tax legislation. Such a balance is also reflected in the treatment of savings accumulated by elderly persons to provide for care during their retirement years. If the Congress had failed to take non-tax considerations into account, elderly persons would not now benefit from an exemption from taxation on the equity realized from the sale of their principal residence and be permitted to use this equity to meet health care and other additional costs during retirement.

5. Other Policy Considerations. Section 7872 would impose a considerable financial burden on elderly residents of continuing care facilities living on fixed incomes. It creates an especially serious problem for continuing care facilities in their ability to attract new residents. A large number of elderly would be reluctant to invest their savings in a

facility where an additional tax burden is imposed on them. All residents are adversely affected by actions that could discourage the entrance of new residents into a facility because the entire financial soundness of a community depends on its ability to maintain maximum occupancy. An unwarrented tax liability would most likely discourage development of new facilties.

Continuing care communities also provide elderly persons with an opportunity to arrange in advance for health care costs and to reduce these costs by sharing risks with others in the community, thus reducing the Medicaid and Medicare costs borne by the government.

The continuing care concept, if properly financed and administered, offers one of the few opportunities for elderly people to provide in advance for a secure and independent retirement. The amount of money paid for a typical CCRC entry fee, if otherwise invested, could not adequately ensure against the potentially devastating health care costs experienced by many elderly persons. Arrangements that minimize reliance on federal health care programs are clearly in the federal interest and should be encouraged by federal policy, not discouraged by misapplied and short-sighted tax and revenue measures.

The Coalition encourages the Committee to consider the impact of this imputed interest requirement on the more than 100,000 elderly residents currently residing in continuing care communities, as well as the thousands who may not have the opportunity to reside in such facilities because the tax law will discourage the development of future communities. We ask the Committee to consider the proposed amendments to the imputed interest bill and to resolve the unintended and inappropriate consequences of the 1984 Tax Act.

American Farm Bureau Federation

1985 MAY 24 PM 1: 14

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May 23, 1985

Honorable Bob Packwood, Chairman
Senate Finance Committee
221 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

The American Farm Bureau Federation is the nation's largest agricultural organization with over 3.2 million member families in 48 states and Puerto Rico. At the 66th Annual Meeting of Farm Bureau last January, voting delegates of the member State Farm Bureaus adopted a position supporting the elimination of the imputed interest rate provisions of the Internal Revenue Code. It has been our concern that this code section has hampered the transfer of farm property, particularly in times of tight credit availability.

The Committee recently held a hearing on the issue that would modify the imputed interest rate provisions. While we continue to support repeal of the imputed interest rate provisions, we support modification of the section to encourage adequate financing for farmers and ranchers in the sale of their farm property.

Thank you for the consideration of our comments, and we ask that this letter be included in the hearing record.

Sincerely,

John Datt

John C. Datt
Executive Director
Washington Office

STATEMENT OF THE
AMERICAN HEALTH CARE ASSOCIATION

ON

CLARIFYING THE APPLICATION OF IMPUTED INTEREST AND INTEREST ACCRUAL RULES OF THE INTERNAL REVENUE CODE

TO THE

U.S. SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

MAY 20, 1985

The American Health Care Association, representing nearly 9,000 licensed long term care facilities, requests Congress to provide the Department of the Treasury with greater guidance for implementation of Section 7872 of the Internal Revenue Code as it pertains to continuing care retirement communities. This Section was added by Section 172 of the Deficit Reduction Act of 1984.

Specifically, we urge Congress to adopt the following technical modifications to Section 7872:

1. to exempt continuing care retirement communities, particularly those which were in development prior to the enactment of the 1984 provision,
2. to exempt entrance fee refunds which occur within the first eight years of occupancy or which conform to refund policies set by state consumer statutes, and,
3. to use the provisions of the current age 55 capital gains exemption on the sales of a home as a precedent for exempting certain refundable entrance fees.

Retirement communities provide optimum arrangements for serving older Americans with dignity and security. They offer a spectrum of cost effective services encouraging maximum independence for residents while assuring professional assistance as needed. A colloquy among Senators Dole, Heinz and Chiles in the Congressional Record of October 11, 1984 (pages S14505-14506) outlines specific problems caused by Section 172 of the Deficit Reduction Act. These problems include:

- undermining consumer initiatives to assure refunds in case of death during early years within a community,
- additional costs to the consumer and provider which add to the costs of services and undermine the financial viability of some communities,
- tremendous anxiety and apprehension concerning the specific regulatory provisions which might be imposed,
- financial hardship for a small number of communities in the development and occupancy stages, and,
- a deterring affect for a favorable privately financed approach to long term care.

The following amplifies the rationale for the technical corrections we strongly believe should be enacted by Congress:

1. **Exemption of Specific Communities**

Perhaps the most pronounced hardship caused by the 1984 provision has been on continuing care retirement communities which were in development or operations at the time of the enactment. The new law only assures that resident contracts entered into prior to June 6, 1984 will not be construed as taxable. Such an approach overlooks the reality that a community's financing is based on the aggregate of its residents contracts. Section 7872 undermines the financial viability of communities conceived, developed and operating under the principles of a refundable entrance fee.

The development process of a retirement community spans several years. Feasibility studies require detailed analysis of the market and the acceptance of different contract features within the market. Financing is secured in large part upon the credibility of the feasibility study. In some states, a certificate to market and the necessary approvals for facility development are based upon these financial calculations. The allocation of construction funds is triggered by the volume of sales, with actual development often tied to guaranteed pre-sold units. This is a complex process, designed to protect both consumers and investors. The key point, is that in such a process one major change undermines the viability of the community. The 1984 tax change clearly forces financial hardship, especially for communities caught in the marketing cycle.

The following situation illustrates some of the specific issues raised by our member homes. After three years of design, marketing, development, construction and staffing, a retirement community opened its doors last July with nearly 75 percent occupancy guaranteed by pre-sales. Section 7872 created a nightmare for the sponsor. Legal questions have arisen as to whether the statute covers contracts entered into, but not fully executed. Marketing problems have occured because consumers do not fully understand why the contract has changed from one offering a refundable entrance fee. Creditors are concerned because they made their financial obligations based upon the feasibility studies which indicated that the community would have contracts which guaranteed a refundable entrance fee. Management has been placed in an untenable position of recalculating escrow accounts for reserves, with such moves further undermining the financial solvency of the community. An atmosphere of uncertainty rather than security prevails.

This composite of consequences is equally applicable to communities operating at the time of the statutory change. Resident turnover is a fact of marketing in retirement communities, and it is most difficult to manage a community with substantially different contracts on a feature as important to financial viability as the question of refundability of entrance fees.

Obviously, this was not the intent of the law. Congress did not have time to fully examine the implications of this provision last session, and there is need to provide guidance to the Department of Treasury to provide specific community exemption. We believe communities which, at least, had completed feasibility studies for financing or had approvals for sale should be exempted.

2. Exemption of Refunds during the First Years of Occupancy

Nearly a decade has passed since the public was first made aware of certain financing practices in continuing care and life-care communities. Since then over a dozen states have enacted specific statutory provisions safeguarding current and future residents of such communities.

One of the questions receiving careful scrutiny is: "What happens if someone decides to withdraw from the community or dies during the early years of occupany?" A few states have answered this concern by mandating specific refund policies while others have made disclosure of refund policies a specific responsibility of the community. Whereas a decade ago it was not uncommon to have a "lock-in" situation whereby a resident would suffer significant financial loss once the contract was signed, current practices are increasingly flexible, offering meaningful refunds. The truism of competitive strategies works in full service retirement communities as the greater freedom to the residents to withdraw has forced providers to be more responsive to their needs. Likewise, in cases of death during early occupancy the estate is preserved and taxed rather than absorbed into the operating revenues of the community.

We recommend a specific exemption from Section 7872 for refunds which occur pursuant to state law or in the early stages of occupancy. It is our understanding that a proposal will be submitted to the Committee recommending an exemption for such refunds during the first 96 months of occupancy. This appears to be a realistic timeframe, suggesting a relationship of the entrance fee to a one percent per month utilization of the sum towards specific operations.

3. Incentive for Private Financing of Retirement Living

Section 121 of the Internal Revenue Code provides a one-time exclusion from income tax for up to $125,000 of gain from the sale of a principal residence by an individual who has attained age 55. This provision was enacted as recognition that the home constitutes a significant resource to the elderly and that the sales proceeds are a significant source of revenues for individuals to care for themselves. Unfortunately, Section 7872 imposes a tremendous disincentive for individuals to take the initiative to plan for their retirement living needs in the most promising of environments.

The proceeds of the sale of the home is a primary source of the entrance fee payment in retirement communities. It would seem logical and prudent to extend the exemption, designed to preserve a person's resources, and allow a rollover of the resources into a continuing care retirement community. Any loss of Treasury revenues resulting from an exemption from the imputed interest provision could easily be offset by a reduction in public outlays for long term health care occurring because individuals divest themselves of resources and prematurely become dependent on Medicaid for their care.

Conclusion

We strongly believe that Congress must continue to assume responsibility for amplifying a coherent policy with respect to aging programs and long term care services. We also believe that individuals must assume a greater responsibility for their own needs. Retirement communities are one of the emerging options which enhances dignity of the resident and opportunity within the market setting to express consumer preferences. Given the tremendous demands being placed upon the delivery system to respond to a spectrum of long term care needs, we believe the positive merits of retirement planning, estate preservation and containment of health expenditures afforded by continuing care communities is worthy of exemption from the onerous burdens of Section 7872 of the Internal Revenue Code.

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May 30, 1985

Honorable Bob Packwood
Chairman, Senate Committee on Finance
U.S. Senate
SD-219 Dirksen Office Building
Washington, D.C. 20510

Attn: Betty Scott-Boom

Re: The Treatment of Imputed Interest on
Deferred Payment Sales of Property

Dear Mr. Chairman:

We are submitting this statement for inclusion in the Committee's record for the May 20, 1985 hearing on the treatment of imputed interest in deferred payment sales of property.

Coopers & Lybrand is an international accounting firm, with 95 offices throughout the United States. A major part of our role in the National Tax office of Coopers & Lybrand is to advise our practice offices and our clients on compliance and planning aspects of new legislation and IRS regulations, rules and procedures. We have, therefore, spent a considerable amount of time analyzing the relevant Code provisions and legislative history that were the subject of House and Senate hearings on imputed interest and an even greater amount of time responding to questions about a variety of issues raised by our practice offices.

Based on our experience with the imputed interest provisions and the comments, questions and concerns raised at these hearings, we have attempted to provide an objective analysis of the current proposals before the Committee so that acceptable permanent revisions to the imputed interest rules may be enacted. We have focused our analysis on two areas, the effects of a cash-cash matched accounting system and a lower imputed interest test rate. We have also commented on the economic accrual of interest.

Our recommendations and observations are as follows:

1. A cash-cash matched accounting system (as well as an accrual-accrual system) should be allowed for all seller-financing transactions. With appropriate policing provisions, congressional policy objectives can be achieved without overly burdening commercially viable sales transactions.

2. A reduction in the test and imputing interest rates may not result in unwarranted tax benefits. In fact, higher test rates may generate greater tax deductions as the term of the loan decreases.

3. Although the economic accrual of interest computation is somewhat complex, we agree that it is necessary to avoid the front-end loading of interest deductions.

A. Background and Introduction

The imputed interest provisions contained in the Tax Reform Act of 1984 (the Act) were intended to further integrate time value of money concepts into the federal tax system. The provisions were enacted to curtail excessive unintended tax benefits and restrict abusive tax shelters by: 1) eliminating the distortions caused by the mismatching of income and deductions by lenders and borrowers in discount lending situations; 2) preventing the mischaracterization of income by manipulating the principal amount of the debt; and 3) preventing the use of a noneconomic formula in computing interest deductions.

Initial attempts to implement the new provisions have been fraught with controversy as the breadth and complexity of the provisions have been more fully realized. The negotiation of sales transactions has been hindered. In particular, the uncertainty created by the provisions has had a deleterious effect on the sales of real property.

In response to the controversy over these new imputed interest rules, Congress passed stopgap legislation in October 1984. One of the primary effects of this legislation was to reduce the test and imputing interest rates. Now Congress must determine how to implement the new provisions on a permanent basis in a way that achieves its policy objectives without undue complexity and without overly burdening commercially viable sales transactions. Our statement addresses the three major policy objectives of the provisions, and we have suggested alternatives for the Committee's consideration where we believe the objectives can be better achieved.

B. Mismatching of Income and Deductions -- Cash-Cash Accounting System

Congress believed that the mismatching of interest income and interest deductions, where the seller was on the cash method and the buyer on the accrual method, had serious revenue consequences because the present value of the deferred income included by the lender in the later period was substantially less than the present value of the deductions currently claimed by the borrower. Accordingly, the Act requires a mandatory accrual method for buyers and sellers in discount lending transactions.

As recognized by the Joint Committee,* the mandatory accrual method presents a problem to sellers in discount lending transactions because interest income must sometimes be recognized without receiving the related cash interest payment.

We believe that the cash-cash matched accounting system between buyers and sellers equally prevents the mismatching of interest income and expense among the original buyer and seller without hindering certain sales of property. The cash-cash method should be an alternative to the mandatory accrual method as an item to be determined by negotiation between the buyer and seller. By limiting interest deductions to those that have economically accrued, a cash-cash system will never generate total deductions in excess of the mandatory accrual system. Also, requiring one system like cash-cash for all transactions, with a joint election to use an accrual-accrual method, would be less complex and would better reach your policy objectives than a situation where transactions under some dollar threshold are on one system and those over it are on another.

However, we recognize that there is a potential for unintended benefits under a cash-cash matched system thus necessitating rules to prevent such benefits and other possible abuses. The

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*References to the Joint Committee statements or positions are per "Description of the Tax Treatment of Imputed Interest on Deferred Payment Sales of Property" prepared by the staff of the Joint Committee on Taxation, April 23, 1985.

Joint Committee has expressed concern that abuses could arise under a cash-cash matched system if the obligation were subsequently transferred to an accrual-basis purchaser or tax-exempt entity. We believe similar problems exist with respect to an accrual-accrual matched system where the obligation is transferred by the seller to a cash-method taxpayer or tax-exempt entity. Both problems can easily be resolved by providing a rule that the original election of a matched accounting system follows the obligation on any transfer by buyer or seller. The Joint Committee has also expressed concern that a seller may borrow against a cash-cash obligation and thus shelter unrelated income. This potential abuse may be prevented by applying rules already established in the Internal Revenue Code in the area of borrowing to purchase or carry tax-exempt obligations and market discount bonds. In addition, the current prepayment of interest rules and the economic accrual of interest limitations will prevent other potential abuses.

It should be noted that the House has approved a cash-cash matching system in limited cases. However, we believe that a cash-cash matched accounting system for all transactions, with appropriate policing provisions, will achieve your policy objectives without overly burdening commercially viable sales transactions. Many of the policing provisions are already contained in other provisions of the Internal Revenue Code and thus should not be overly burdensome or complex in their implementation. Furthermore, a cash-cash system for all transactions would avoid the need for a complex set of aggregation rules. We also recommend that an accrual-accrual system, if elected by both the buyer and seller, should also be allowed.

C. Mischaracterization of Income -- Test and Imputing Rates

Congress believed that it was possible for taxpayers in a sale of nontraded property for nontraded debt to achieve unwarranted tax benefits by manipulating the principal amount of the debt. This mischaracterization of interest as principal resulted in an overstatement of the sales price and the tax basis of the property. In cases where the property was a capital asset in the hands of the seller, interest income could be essentially converted to capital gain. If the property were depreciable in the hands of the purchaser, excessive cost recovery deductions could be claimed.

To eliminate this mischaracterization of income, the fair market value of the property must be determined. Congress believed that this valuation problem would best be resolved by valuing the debt instrument rather than valuing the property. The mechanism for valuing the debt instrument is the test interest rate. If the debt instrument does not meet the test rate, a new issue price is determined using a higher imputing interest rate (under the Treasury revised proposal, the test and imputing rates would be equal). The test and imputing rates essentially determine three important tax attributes: 1) the sales price, 2) the depreciable basis of the property, and 3) the interest income and expense to be reported.

The Joint Committee has provided examples (pages 16 to 18) of the potential and purportedly abusive overstatement of depreciable basis using a test rate of 80 percent and 100 percent of the AFR compared to an assumed market interest rate of 110 percent of the AFR. We believe that such examples are somewhat misleading as they assume 100% of the property is leveraged and fail to truly examine the net tax benefits and related tax planning upon the acquisition of depreciable property.

A buyer of depreciable property recognizes tax benefits from both depreciation and interest deductions. As the test rate increases, the total amount of depreciation is reduced (i.e., the basis of the property is reduced), and the total amount of interest deductions is increased (i.e., the interest rate is higher). By assuming that the buyer and seller are in 50 percent tax brackets and, therefore, that the interest amounts have no effect on tax revenues, the Joint Committee's examples overlook the effects of the increased interest deductions. This assumption should be re-examined.

It is often the case that a seller of property is not in a 50 percent tax bracket. This may be due to tax-exempt status, installment sale treatment, loss carryovers, or simply other deductions. The Joint Committee later recognizes (page 27) a tax bracket differential where a tax-exempt or foreign entity may be involved. As a practical matter, the abuses in this area generally involve the acquisition of depreciable property by tax-shelter investors and other high tax bracket taxpayers. Such taxpayers are interested in total deductions, not just depreciation deductions.

We believe the focus should be on the total deductions generated upon the acquisition of depreciable property and on whether a lower test rate will yield significantly greater tax benefits than those under a 110 percent test rate. With this objective, we have re-examined the Joint Committee's examples, analyzing the total deductions generated utilizing various test rates, and have found that lower rates generally do not yield unwarranted tax deductions.

It must be emphasized that any analysis of the effects of higher or lower test rates must be made in light of general industry practice. Thus, it should be noted that most seller financing of real property is for a term of 10 years or less. After such time, the property is sold or the seller financing is paid off with non-seller financing. Furthermore, most real estate investments are typically held for only a period of approximately eight to 10 years.

With this in mind, a re-examination of the Joint Committee's examples indicate the following:

1) The perceived basis overstatement and related depreciation deductions resulting from an 80 percent test rate, as compared to a 110 percent test rate, are to a great extent offset by lower interest deductions. For instance, a 25 percent basis overstatement on a 10-year note and an 80 percent rate results in only a five percent difference in total deductions. See Table III.

2) When the term of the loan is from five to 10 years (i.e., a typical real estate loan in today's marketplace), the basis overstatement is substantially reduced. In fact, a 110 percent rate may generate greater total deductions where commercial (nonresidential) property is involved. For example, assuming a seven year note and straight-line depreciation (which is typical for commercial real estate), a 110 percent rate generates three percent more tax deductions after eight years than under an 80 percent rate. The deductions are even greater when the loan term is five years. See Tables I and II and related graph.

3) In many seller-financed real estate transactions, the purchaser is acquiring land as well as depreciable property. In these cases, the use of higher test rates often magnifies the tax shelter potential of the purchaser by allowing the purchaser to take higher interest deductions. See Tables III and IV.

In summary, a complete analysis of a purchaser's total tax benefits indicates that a decrease in the test rate, in today's real estate market, will not generate unwarranted tax benefits. It should also be noted that these sorts of analyses can not quantify the increase in economic activity that lower test rates may generate.

It should be noted that our analysis is based on the Joint Committee's assumption that 110 percent of the applicable federal rate approximates the market rate in real estate transactions. At the May 20, 1985 hearing, representatives of the real estate industry challenged this assumption. The Joint Committee supports the validity of the 110 percent rate in tables on pages 22 and 23 that compare the yield on 10-year United States Government Securities to Government Sponsored Mortgages and Mortgage-backed Securities. We would observe that the comparison made by the Joint Committee is somewhat misleading, since it compares 10-year securities to much longer term mortgages and then makes assumptions with respect to the lender holding the mortgage to maturity.

It should be noted that the House has approved a reduction in test rates in H.R. 2475, as reported. However, a review of the estimated revenue effects may be warranted, given the questions noted above concerning the assumptions used to develop these estimates.

D. Economic Accrual of Interest

Congress believed that significant distortions occurred under prior law in the form of noneconomic accruals of interest. To alleviate this concern, the Act provided that interest must be allocated to each tax accounting period in a manner consistent with the yield-to-maturity method. We agree that such interest computation method is necessary to avoid the front-end loading of interest deductions. However, it should be noted that the yield-to-maturity method is rather complex. Thus it may be appropriate to exempt certain small transactions from these rules.

E. Conclusion

In conclusion we believe the analysis and recommendations discussed above deserve further attention as the Committee searches for a clearer overall approach to the imputed interest provisions. We believe the Act's basic goals would not be compromised by these changes and that greater public support would result.

We sincerely appreciate this opportunity to submit our comments. Should you have any questions, please do not hesitate to contact me or Mark B. Brumbaugh, a partner in our National Tax Consulting Office.

Sincerely,

Ira H Shapiro

Ira H. Shapiro
Director of Tax Policy

APPENDIX

ANALYSIS OF ALTERNATIVE TEST RATES

Summary of Conclusions

1. When the loan term is less than 10 years, the 110% test rate will generate greater tax deductions (i.e., constitute a better tax shelter) than under an 80% test rate. It should be noted that most seller financing is for a period of less than 10 years.

2. When the loan term approximates 10 years, the 80% and 110% test rates generate approximately the same total deductions over the first 8 years. Eight to 10 years is the average holding period of a real estate investment.

3. The Joint Committee's focus on the perceived basis overstatement is misleading in that it fails to consider the total deductions, (i.e., depreciation and interest). Thus, a 25% basis overstatement using an 80% rate results in only 5% greater total deductions.

4. The Joint Committee's computation of the basis overstatement is misleading because it assumes that all basis is allocable to depreciable property. In fact, land, a nondepreciable item, is generally purchased with a building. The use of a higher test rate often magnifies the tax shelter potential of the purchaser.

Assumptions & Observations

1. The following tables are based on the same assumptions in the Joint Committee's analysis of the tax consequences of understatement of interest. In short, the computations assume:

    a) A present value of principal and interest payments of approximately $100,000,000

    b) Current payment of interest and a balloon payment of principal

    c) 110 percent of the April applicable federal rates are 13.49% for loan terms in excess of 9 years and 13.06% for loan terms between 3 and 9 years.

2. Depreciation deductions were computed on a straight-line basis over 18 years which is typical of commercial (nonresidential) real estate. It should be noted that residential real estate is typically depreciated on an accelerated basis.

3. In today's market place, real estate investments are generally held 8 to 10 years. Thus, it is important to focus on the total deductions over such period.

4. In today's market place, seller financing is generally for a period of 5 to 10 years. Thus it is important to focus on the tax deductions arising under such loan terms.

Legend

Depreciable Basis -- Dollar amount allocated to depreciable property based on a present value of principal and interest payments of $100,000,000.

Total Deductions -- Total amounts allocated to interest and depreciation over a 19-year period. Eighteen-year real property depreciated on a straight-line basis is generally written-off over 19 years.

Total Deductions in First 8 Years -- Total interest and depreciation deductions in the first 8 years.

TABLE I

TEST RATE COMPARISON
5 YEAR LOAN TERM

(Dollar Amounts in Millions)

Test Rate as Percent of AFR	DEPRECIABLE BASIS		TOTAL DEDUCTIONS		TOTAL DEDUCTIONS IN FIRST 8 YEARS	
	Total	Percent of 110% Amount	Total	Percent of 110% Amount	Total	Percent of 110% Amount
80	$114.5	114.5	$168.9	102.1	$108.2	96.2
90	109.2	109.2	167.6	101.3	109.7	97.5
100	104.8	104.8	166.6	100.7	111.1	98.8
110	100.0	100.0	165.5	100.0	112.5	100.0

TABLE II

TEST RATE COMPARISON
7 YEAR LOAN TERM

(Dollar Amounts in Millions)

Test Rate as Percent of AFR	DEPRECIABLE BASIS Total	DEPRECIABLE BASIS Percent of 110% Amount	TOTAL DEDUCTIONS Total	TOTAL DEDUCTIONS Percent of 110% Amount	TOTAL DEDUCTIONS IN FIRST 8 YEARS Total	TOTAL DEDUCTIONS IN FIRST 8 YEARS Percent of 110% Amount
80	$118.9	118.9	$198.0	103.3	$135.0	97.3
90	111.9	111.9	195.7	102.1	136.4	98.3
100	106.1	106.1	193.7	101.0	137.5	99.1
110	100.0	100.0	191.7	100.0	138.7	100.0

TABLE III

TEST RATE COMPARISON
10-YEAR LOAN TERM WITH ZERO ALLOCATION TO LAND

(Dollar Amounts in Millions)

Test Rate as Percent of AFR	DEPRECIABLE BASIS		TOTAL DEDUCTIONS		TOTAL DEDUCTIONS IN FIRST 8 YEARS	
	Total	Percent of 110% Amount	Total	Percent of 110% Amount	Total	Percent of 110% Amount
80	$124.6	124.6*	$246.7	105.0	$156.2	100.8
90	115.4	115.4	242.3	103.1	155.8	100.5
100	107.5	107.5	238.7	101.6	155.4	100.3
110	100.0	100.0	235.0	100.0	155.0	100.0

*Amount differs from Joint Committee's 125% amount because the Joint Committee rounded the 80% test rate from 9.79% to 9.70%.

TABLE IV

TEST RATE COMPARISON
10-YEAR LOAN TERM WITH 20% ALLOCATION TO LAND

(Dollar Amounts in Millions)

Test Rate as Percent of AFR	DEPRECIABLE BASIS		TOTAL DEDUCTIONS		TOTAL DEDUCTIONS IN FIRST 8 YEARS	
	Total	Percent of 110% Amount	Total	Percent of 110% Amount	Total	Percent of 110% Amount
80	$99.7	124.6	$221.8	103.2	$144.5	99.2
90	92.3	115.4	219.3	102.0	144.9	99.5
100	86.0	107.5	217.2	101.0	145.3	99.8
110	80.0	100.0	215.0	100.0	145.6	100.0

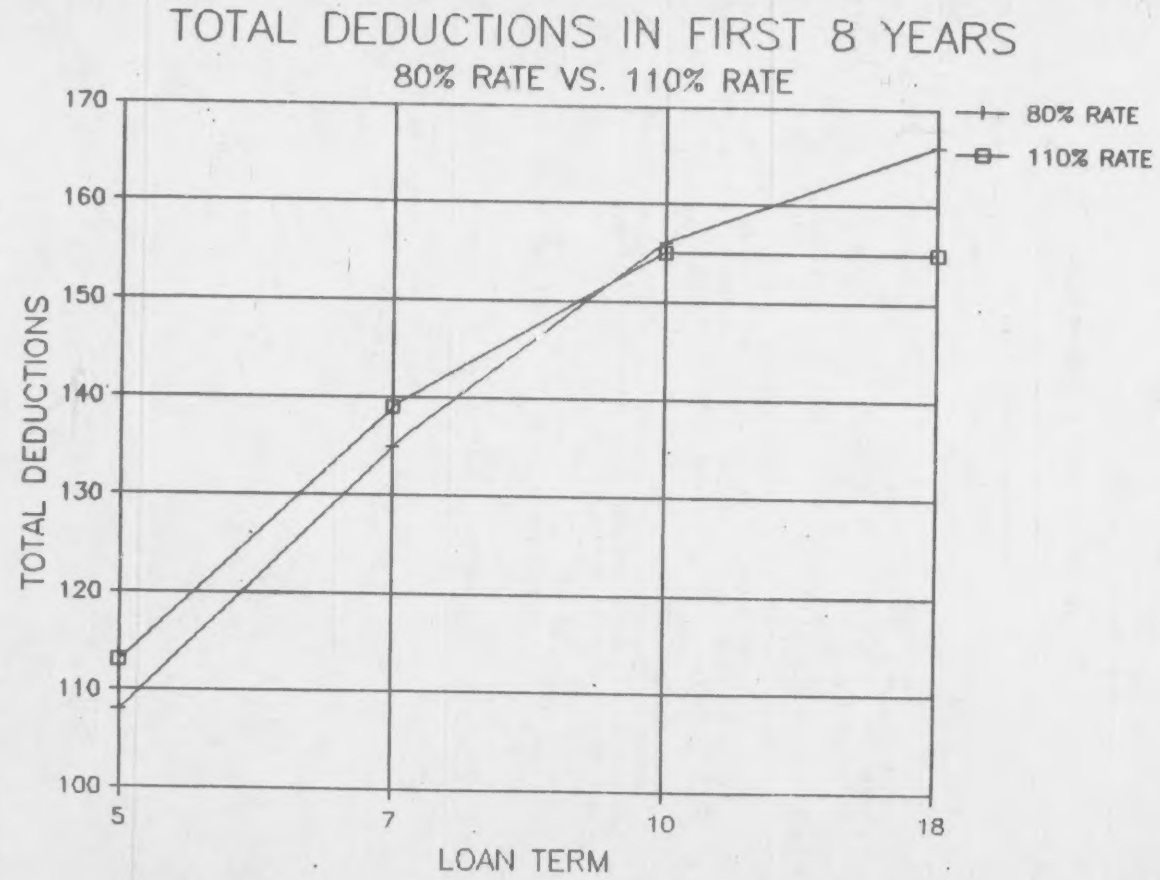
TABLE V

TEST RATE COMPARISON
18-YEAR LOAN TERM

(Dollar Amounts in Millions)

Test Rate as Percent of AFR	DEPRECIABLE BASIS		TOTAL DEDUCTIONS		TOTAL DEDUCTIONS IN FIRST 8 YEARS	
	Total	Percent of 110% Amount	Total	Percent of 110% Amount	Total	Percent of 110% Amount
80	$132.7	132.7*	$366.6	106.9	$166.3	107.3
90	120.0	120.0	357.6	104.3	162.0	104.5
100	109.5	109.5	350.0	102.0	158.3	102.1
110	100.0	100.0	343.0	100.0	155.0	100.0

*Amount differs from Joint Committee's 133.4% amount because the Joint Committee rounded the 80% test rate from 9.78% to 9.70%.


TOTAL DEDUCTIONS IN FIRST 8 YEARS
80% RATE VS. 110% RATE
80% RATE
110% RATE
TOTAL DEDUCTIONS
170
160
150
140
130
120
110
100
5
7
10
18
LOAN TERM

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21 May 1985

Ms. Betty Scott-Boom
Committee on Finance, Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Ms. Scott-Boom:

Five bills that would amend the Internal Revenue Code to clarify the application of imputed interest rules (S. 56, S. 71, S. 217, S. 251 and S. 729) will be reviewed by the Senate Finance Subcommittee on Taxation and Debt Management, on May 20, and written comment has been requested by May 30.

My problem with imputed interest, is that the rates required are often in excess of the rate of interest an individual can legally charge on such loans in Louisiana, and I believe in certain other states. It would appear that the federal government should not require a rate of interest that is an illegal rate in certain states. The imputed rate is higher than the allowable rate, and if the state does not allow a note to call for the allowable rate, the citizens of that state are then penalized with the higher imputed rate.

It seems unusual that I haven't seen this problem expressed in any of my tax services, and I would address that concern to this committee.

Sincerely,

Charles F. Buckley

CFB:bw

JOINT STATEMENT OF THE
CLUB CORPORATION
OF AMERICA AND
THE NATIONAL CLUB ASSOCIATION

on

THE IMPUTED INTEREST
PROVISIONS OF SECTION 7872
OF THE INTERNAL REVENUE CODE

to the

SENATE FINANCE COMMITTEE

May 29, 1985

I. INTRODUCTION AND SUMMARY

The Club Corporation of America ("CCA") is headquartered in Dallas, Texas, and currently owns and operates 165 social clubs located in 39 states. CCA and its clubs are for-profit stock corporations, which are fully taxable for federal and local purposes.

The National Club Association ("NCA") represents approximately 750 social clubs which are tax-exempt under Section 501(c)(7) of the Internal Revenue Code. It also represents about 250 private social clubs which are not tax-exempt, either because they have chosen taxable membership club status (under I.R.C. Section 277 and other statutes), or because they are for-profit stock clubs.

CCA and NCA submit this statement in order to set forth their objections to certain parts of the newly enacted Section 7872 of the Internal Revenue Code, dealing with imputed interest. Specifically, we submit that Code Section 7872(c)(1)(E) will yield little revenue, but will instead impede expansion and growth of social clubs and cause complex and costly administrative problems.

Section 7872(c)(1)(E) is a catch-all provision entitled "Other below-market loans." The provision is totally open-ended in definition and scope, and could subject thousands of types of ordinary-course-of-business loans to complex regulation and taxation. Unlike other parts of Section 7872 (e.g., intra-family loans), Section 7872(c)(1)(E) contains virtually no standard for inclusion or exclusion, but merely delegates that decision to Treasury Regulations. Many taxpayers have already come to Treasury with hitherto unknown types of bona fide but potentially covered transactions, and Treasury threatens to become swamped as limited staff try to separate "good" from "bad" below-market loans.

Nowhere would the adverse impact of Section 7872(c)(1)(E) be greater than on social clubs. Below-market loans from members constitute the main capital financing device for many clubs. They are the economic equivalent of ordinary equity financing, and constitute the main practicable financing device for for-profit clubs; even for non-profit clubs, loans are easier to administer than equity infusions in many instances.

Potential implementation of Section 7872(c)(1)(E) could stop in its tracks the growth of for-profit clubs, eliminating over 2,000 new jobs and $50 million in new construction per year. The statute could also seriously hurt the nonprofit club industry --

which has been barely holding its own in recent years. The result could be an even greater loss of jobs and economic growth.

Moreover, Section 7872(c)(1)(E) could result in I.R.S. being deluged with millions of Form 1099's, each containing its own figures based on its own complex mathematical computation. I.R.S. Service Centers cannot handle their present burden of paperwork, and such forms are unlikely to be fully processed.

For these reasons, CCA and NCA vigorously urge repeal of Section 7872(c)(1)(E). Alternatively, we urgently request that the statute be amended to exempt: (i) all below-market loans to the extent they are less than $10,000; (ii) all below-market loans which are used for capital financing purposes and are not a substitute for the lender-member's payment of club dues and fees; (iii) all member loans to clubs which entitle the member to equity rights, such as voting and sharing of assets on dissolution; and (iv) required member loans to a club which are comparable in size and timing to required equity payments by similar clubs in the same retail trade area.

II. THE STRUCTURE OF SECTION 7872 OF THE CODE

Section 7872 of the Code provides detailed rules for the taxation of certain types of "below-market" loans. The enactment of the statute was precipitated by below-market loans among family members; from employers to employees; and from corporations to shareholders.[1] These situations are covered by Section 7872(c)(1)(A)-(C) of the statute. Further, Section 7872(c)(1)(D) covers below-market loans one of whose principal purposes is tax avoidance. These provisions do not affect CCA or NCA clubs, and we take no position on them.

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[1] See H. Conf. Rep. No. 98-861, 98th Cong., 2d Sess. 1011-1019 (1984).

However, Section 7872(c)(1)(E) describes an additional class of below-market loans covered by the Statute, termed "Other below-market loans." This class is broadly described to be "any below market loan * * * if the interest arrangements of such loan have a significant effect on any Federal tax liabilities of the lender or the borrower." Section 7872(c)(1)(E) gives the Treasury Department authority to issue legislative Regulations to determine which below-market loans are covered because they have a "significant effect on tax liabilities", and which are exempted. The statute gives no guidelines as to how these determinations are to be made. There is no clue as to whether "significant effect" in Subparagraph (c)(1)(E) intends a qualitative or standard, or whether a relative or absolute quantitative measure is intended. The term "effect on tax liabilities" is also left open ended; indeed, a below-market loan could have a net positive "effect" on tax revenues and still be covered under the literal terms of Section 7872. As a result, the statute gives the Treasury Department virtually unfettered authority to adjudge the "rightness" or "wrongness" of hundreds or even thousands of types of below-market loans.

III. SECTION 7872(c)(1)(E) POTENTIALLY ENCOMPASSES MYRIADS OF TYPES OF ORDINARY-COURSE-OF BUSINESS LOANS.

These provisions hang like a sword of Damocles over the business community and society at large, including the billion dollar club industry. Throughout our economy, innumerable below-market loans occur daily, for thousands of sound business, non-tax reasons. So broad are the statutory terms that the Joint Committee Bluebook has found it necessary to opine that the statute should not cover loans by financial institutions in the ordinary course of their trade or business; insurance policy loans; government-subsidized loans; and below-market charitable loans by philanthropies.[2]

In our economy, individuals and businesses provide funds to others on a below-market-rate basis in probably millions of types of genuine, bargained for business circumstances. For example, banks and other business interests in a community commonly furnish CCA clubs some capital funds at below-market-rates, simply because they feel that a CCA club will improve the business community. Businesses provide below-market loans to suppliers to ensure a steady flow of supplies, finance inventory, help the supplier through hard times, etc. Depositors in effect loan funds to banks at passbook rates in order to obtain ease of access to funds. Banks require no-interest compensating balances from customers as security or accommodations. Down payments can be viewed as a form of interest-free loans. The list goes on and on. Only the most optimistic advocate of economic regulation by central government would vouch for the Treasury's ability to define and properly classify as "good" or "bad", under the meaningless statutory terms, the myriads of other types of below-market loans in the American economy.

2/ General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, p.532.

The result is that Section 7872(c)(1)(E) is a serious potential threat to the business and economic community, threatening to destroy viable and genuine business tranactions at the mere stroke of Treasury's pen. If a particular type of below-market loan is determined to be subject to Section 7872, the consequences can be disastrous. The borrower may have to realize a large portion of the loan proceeds as taxable income in the year of the loan if it is a term loan. Whether the loan is a term or demand loan, the lender and borrower will find that they have become subject to complex and expensive provisions governing calculation of imputed income, withholding, reporting, and recordkeeping. Where a type of below-market loan is repeated in the ordinary course of business, the administrative complexities and burdens of coverage under Section 7872 can make the transaction impracticable. Thousands of complex, disparate calculations (200,000 for CCA alone) must be made; I.R.S. Form 1099's must be sent to each lender; and the imputed interest rules must be explained to customers or suppliers. In many cases, these complexities will simply make a transaction unfeasible.

The administrative problems in Treasury's implementation of Section 7872 are also formidable. The Treasury and I.R.S. have already experienced continuing delays in issuing Regulations or other guidelines. Temporary Regulations were predicted last year, but numerous delays have ensued, and the Tax Legislative Counsel recently quoted a date of Summer 1985 for the first

Proposed or Temporary Regulations.[3/] It is unlikely that such Regulations will even address the class of "Other below-market loans."

IV. SECTION 7872(c)(1)(E) COULD FATALLY IMPAIR THE FINANCING OF FOR-PROFIT CLUBS

In the case of CCA and other for-profit clubs, application of Section 7872 to their ordinary-course-of-business financing arrangements would be unfair and cripple their growth. In order to understand why this is so, it is necessary to understand how CCA finances its tremendous capital growth. CCA started with one club in 1957, and has grown by constructing new clubs, and acquiring established clubs which were in economic distress. It has expanded and prospered by extending club membership to moderate income persons. CCA clubs have succeeded by selling club memberships on the basis of quality services at reasonable prices, rather than relying on exclusivity of access or luxurious facilities.

Members purchase club services from CCA clubs like they purchase other services in the marketplace. CCA furnishes food, beverages, and other club services at ordinary, competitive prices. In 1984, members and guests of CCA clubs paid over $98 million in dues, and over $103 million for food, beverages, parties, and other fee services. Average monthly dues were $41.53 for city clubs and $74.73 for country clubs.

The above charges were for current services, however, and did not cover the capital costs of CCA clubs, such as construction, renovation, and replacement costs. If CCA's dues

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[3/] See April 15, 1985 Tax Notes, p.229.

and fees were to cover such capital costs, they would not be competitive with competing tax-exempt clubs, which usually pay capital costs from equity contributions. CCA accordingly finances its capital costs with 30-year, no-interest loans which members make when they join. Commercial loans cannot finance most of CCA's capital needs, because every bank lender demands that a borrowing club obtain substantial financial commitments from the club members in the form of loans, to ensure that the members will continue to patronize the club and pay sufficient dues and fees to service the bank debt. In 1983, the average member loan was $607; total member loans made in that year by new members totaled about $19 million.

CCA has been enormously successful in marketing club services to the general population. It started with one club in 1957, and has doubled in size every three to five years. Consistent with past growth, CCA projects its future expansion as follows:

	1984	1988
Number of clubs	159	350
Gross receipts	$262 million	$500 million
Operating profits	$9.0 million	$21.0 million
Employees	8,000	20,000
Taxes	$12 million	$19 million

Over $250 million in construction and renovation is projected during the next 5-year period.

This enormous past and future growth is an important component in stimulating the nation's economy, and in generating the federal, state and local tax revenues paid by CCA and its employees. However, application of Section 7872 to the capitalization of these clubs -- a capitalization undertaken by the customer members in arms-length business arrangements with CCA proprietary clubs -- would impair or even halt this thriving consumer industry.

2. Member loans to for-profit proprietary clubs like those of CCA do not have a significant effect on the tax liabilities of the members or the clubs. Member loans to CCA clubs arise out of an ordinary business transaction between unrelated service providers and customers. Banks absolutely require the subordinated member capital furnished by such loans, as a prerequisite and as security for the capital furnished through commercial loans. No-interest member loans are essential to allow for-profit taxpaying clubs to compete with tax-exempt clubs, which obtain much of their capital from nontaxable equity contributions. Thus, in economic effect,these loans are really quasi-equity infusions from members.

No-interest member loans do not involve any tax avoidance. The loan funds merely represent a recreational asset in which the member chooses to invest in an ordinary business tranaction. If the member did not make the loan and join the club, he would just as likely purchase some other recreational asset, such as a boat, a patio, exercise equipment, or the like, which would generate no taxble income. In spite of the member loan, the club member still pays ordinary dues and fees for services, which CCA, as an entrepreneurial owner, prices to sell at the highest levels which the market will bear. Such dues and fees are fully taxable to CCA.

Most importantly, application of Section 7872 to CCA's member loans would not produce more tax revenues, but would merely make club membership prohibitively expensive, dry up the prime source of capital to proprietary for-profit clubs, and drive customers elsewhere for recreation. In short, the application of Section 7872 will produce less tax revenue. Here is the scenario:

a. Each CCA club requires a certain amount of capital in order to be built.

b. If a major portion of this capital is taxed by application of Section 7872, one of two things will happen:

    i. The tax will reduce the capital generated so that new clubs cannot be built; or

    ii. CCA will have to increase the dues charged incoming members to artifically high levels (above the competition's) to end up with the same after-tax dollars needed to build the club. At such high dues levels, prospective members won't join and the clubs won't be built.

c. Without new clubs being built, the vehicle for creating taxable revenues ceases to exist. Tax revenues do not grow in a stagnant or declining industry.

In addition, the computation and reporting costs of applying the statute to CCA's prospective 200,000-plus members -- not to mention the member confusion at being taxed on unearned income -- would be an enormous burden on this business.

3. We have carefully reviewed the financial statistics for a number of CCA clubs over the past 10 years, and have projected the amount of extra bank debt and current income which they would have needed assuming Section 7872 had applied and imputed dues income to the clubs. We are convinced that these clubs could not have been built if Section 7872 had been so applied. Cash flow would have been severely reduced and would not have supported the higher debt service requirements. Accordingly, CCA would not have taken the additional risks, nor would the banks have made the required additional short-term operating loans.

For-profit proprietary clubs like CCA primarily exist to maximize profits for their owners, and compete in the marketplace with restaurants, bars, health clubs, hotels and other taxpaying businesses, as well as the nonprofit clubs. CCA's intent is thus to maximize every source of revenue, within competitive constraints, not to bestow tax benefits on unrelated members. In such circumstances, examples of abuses in the statute or committee reports, involving related paties (e.g., corporation-shareholder), should not be extended to cover ordinary commercial transactions -- like member loans to clubs -- through the catchall "Other below-market loans" provision of Section 7872(c)(1)(E).

Member loans are, in fact, the only practical competitive tool that CCA can use which can act as a close equivalent of the capital contribution made by an incoming member in a not-for-profit club -- most of which are tax-exempt by statute.

Indeed, in the case of CCA, as in the case of most businesses, below-market transfers of all types are everyday occurrences. For example, banks sometimes loan CCA funds at below-market rates for many reasons -- e.g., to increase traffic in a bank-owned or occupied buildings. Landlords frequently provide below-market rent to CCA clubs for the similar reasons. These and other below-market transactions have nothing to do with tax avoidance, and should not be shackled and stifled with the bureaucratic complexities and restrictions of Section 7872.

If Section 7872(c)(1)(E) is not repealed or amended, accountants and lawyers for for-profit clubs may require clubs to note enormous contingent libilities on financial statements. Banks will be reluctant to participate in co-financing programs with members because of the potentially large tax liabilities of clubs. Many capital projects will simply be dropped because of the expansive language of the statute. No matter how urgent the below-market financing, members and other potential lenders may become unwilling to risk below-market loans to clubs in view of the broad languge of the statute.

V. SECTION 7872(c)(1)(E) MAY GRIEVOUSLY IMPEDE THE FINANCING OF TAX-EXEMPT CLUBS.

The "Other below-market loans" provision in Section 7872(c)(1)(E) may also have serious and substantial adverse effects on nonprofit social clubs. The provision could be interpreted to cover a wide variety of club financing arrangements. For example, it may apply to: (i) below-market, required member loans to pay for clubs' construction and other capital costs; (ii) required member equity payments to clubs to finance capital projects; (iii) hybrid forms of debt-equity payments typically paid by members as capital contributions; (iv) security deposits needed to ensure payment of club dues and fees. Such an interpretation would cause grave injury to tax-exempt clubs. Under Section 7872(C)(1)(E) as it now reads, there is a great deal of uncertainty as to its application to member capital financing of tax-exempt clubs.

VI. RECOMMENDATION FOR REPEAL OR AMENDMENT OF SECTION 7872(c)(1)(E)

In summary, Section 7872(c)(1)(E) could have disastrous effects on the capital financing arrangements of social clubs. For this reason, CCA and NCA wholeheartedly recommend repeal of this provision.

Even if the Finance Committee failed to recommend repeal Section 7872(c)(1)(E), it should substantially limit its scope to situations where a below-market loan clearly results in a substantial diminution of federal tax revenues. In this respect, we suggest the following amendments to Section 7872(c)(1)(F).

1. A below-market loan from a member-club-lender, to a borrower would not be subject to Section 7872 to the extent that such loan is $10,000 or less.

2. A member's below-market loan to the member's club will not be subject to Section 7872 if the loan proceeds are designated and used for capital items, rather than as a substitute for current dues or other current fees.

3. A member's payments to a club which entitles the member to equity rights, such as the right to vote or a greater share of the club's assets on dissolution, should not be subject to Section 7872.

4. A member's below-market loan to a club should not be subject to Section 7872 if it is comparable in size and timing to equity payments or below-market loans of other clubs in the Retail Trade Area in which the club is located.

May 30, 1985

WRITTEN STATEMENT
IBM CREDIT CORPORATION

Hearings Before the Subcommittee on
Taxation and Debt Management

United States Senate Finance Committee

Tax Treatment of Imputed Interest on
Deferred Payment Sales of Property
May 20, 1985

IBM Credit Corporation ("IBM Credit") is a wholly-owned subsidiary of International Business Machines Corporation, ("IBM"). This statement describes some presumably inadvertent problems which the imputed interest rules have created for IBM and IBM Credit and suggests solutions to them. These problems arise mainly because the imprecise framework of Section 1274 does not address the special nature of installment obligations for which principal is amortized monthly. The Ways and Means Committee of the House of Representatives addressed the problems created by the imprecision in Section 1274 in H.R. 2475 by authorizing Treasury to issue regulations permitting taxpayers to use rates lower than the applicable Federal rate in appropriate cases. The Treasury has testified in its statements to the Ways and Means Committee and the Finance Committee ("Treasury statement") that it would welcome confirmation of legislative authority to provide taxpayers with alternate means of proving adequate stated interest.

The alternate means of proving adequate stated interest suggested in the Treasury statement, when fully implemented, would substantially solve the problems which section 1274 has created for IBM and IBM Credit. IBM Credit supports the Treasury statement in this regard. A provision similar to the proposed revised Section 1274(d)(1)(D) of H.R. 2475 should be included in the Senate bill dealing with imputed interest.

BACKGROUND

IBM develops, produces, manufactures and sells data processing machines and systems, telecommunications systems and products, information distributors, office systems, typewriters, copiers, educational and testing materials, and related supplies and services. IBM Credit purchases and leases IBM products and purchases installment payment agreements ("IPAs") which result from installment sales of IBM products.

The Tax Reform Act of 1984, adding Internal Revenue Code section 1274, expanded the scope of prior Code provisions determining whether interest rates charged in certain seller financed transactions are reasonable. These modifications to the imputed interest provisions were intended to prevent a seller from artificially depressing the interest rate on an obligation issued in exchange for property while increasing the obligation's stated principal to achieve a greater investment tax credit for the buyer. However, in practice, the new imputed interest rules overreach their intended bounds and interfere with legitimate non-tax motivated business transactions.

Section 1274 creates a special problem for equipment manufacturers such as IBM who sell equipment in installment sales. The problem arises because the test interest rates, used to determine the existence of unstated interest on an obligation, at times may be higher than actual market rates used by IBM for installment obligations received in such sales. The rate that is charged on IBM's 4 and 5 year IPAs to large credit-worthy customers has in the past (see Illustration A) and may in the future fall below published testing rates. As a result, IBM and other manufacturers are placed at a competitive disadvantage with respect to third parties that are able to finance the purchase of the same equipment without regard to the imputed interest rules. When the testing rates are too high, a manufacturer must either raise its interest rates above market or subject its customers to a partial loss of investment tax credit.

The testing rates under section 1274 may be too high for IBM's IPAs principally for three reasons: (1) Testing rates for installment debt instruments may be determined by reference to the final maturity of the installment obligation ignoring the fact that most principal is amortized in advance of final maturity; (2) The application of only three testing rates for all maturities of debt instruments is an approximation which is too broad; and (3) The testing rates lag market rates by an average of one to two months.

DISCUSSION

The application of section 1274 to IBM installment sales gives a prime example of the shortcomings of the testing rates. IBM sells its products to customers at selling prices established under standardized pricing policies that do not vary depending upon whether the transaction is for cash or credit. In fact, the majority of its sales are for cash (some 89% of domestic new equipment sales in 1984).

Under the business relationship between IBM and IBM Credit, the interest rates charged on IBM's IPAs are determined by IBM Credit. IBM Credit purchases all of IBM's IPAs, and only the profits of IBM Credit are affected by the interest rates on installment sales. Conversely, IBM Credit's profits are independent of the selling price of IBM products. As an independent profit center, IBM Credit's management objective is to maximize profits from the financing and lease transactions in which it engages and not from the sale of IBM products.

IBM Credit sets the interest rates charged on IBM IPAs weekly, based upon current interest rates in the competitive market for financing. For transactions in excess of $1 million, rates are set based on market indices, currently the weekly average of the rates on 2, 3, 4 and 5 year Treasury bills, plus a step-up to reflect the credit of the borrower and the administrative costs of the transaction. The rates on

IBM's IPAs therefore reflect the fact that principal on the obligations is repaid with each monthly installment, i.e., some principal matures in years 1, 2, 3, and 4 as well as in year 5.

Sections 1274 and 483 in their current form fail to adequately account for this self-amortization of installment obligations, despite an implicit Congressional recognition that market interest rates differ according to the maturity of a debt instrument, with higher interest rates corresponding to longer maturities. In enacting section 1274, Congress provided three different testing rates, dependent upon the "term" of the debt instrument. However, the word "term" could be construed to refer to the last maturity date of an obligation, without recognition of prior maturity dates. In the case of a balloon note, this construction would be reasonable. However, the word "term" so construed would not account for the amortization of principal over time that occurs in installment obligations.

As a result, the adequacy of stated interest on IBM's 5-year IPAs may be measured by a testing rate established by reference to 110 percent of the average rate on treasury obligations maturing in 4 through 9 years -- a maturity much longer than the average 2.5 to 3 year maturity of the IBM 5-year IPAs. IBM's interest rates on certain 5-year IPAs for large credit-worthy customers at times were lower than the 4 to 9 year maturity testing rates under section 1274. Therefore, if section 1274 is applied to the

IBM 5-year IPAs using the 4 to 9 year maturity test rates, it would require an imputed principal amount for these sales below IBM's ordinary cash price for similar products.

The use of only three testing rates, corresponding to short-term, mid-term, and long-term maturities, compounds the current inaccuracies in the determination of the applicable federal rate under Section 1274. For example, this broad approximation fails to reflect the differences in risk associated with a 4 year debt instrument and a 9 year debt instrument. Section 1274 therefore interferes with the normal market processes which assign higher interest rates to debt instruments with longer terms.

The testing rate described by section 1274 also interferes with the normal processes through which businesses set their market rates. Because of the minimum 6-week time lag, businesses which set rates on a weekly or even daily basis, to more accurately reflect the market, ironically may suffer the consequences which should be reserved for tax-motivated actions. Although the monthly applicable federal rates adopted in Treasury regulations and proposed in H.R. 2475 narrow this problem, it remains a serious obstacle to the ordinary business practices of taxpayers that change rates more often than monthly.

Section 1274 also inappropriately penalizes sellers who set rates on the date on which the customer takes delivery of the purchased property. By statute, the testing rate must be set as of the date on which a binding contract for a sale or exchange exists. Businesses which set interest rates as of the date of the actual exchange of property therefore may fail to meet the testing rate solely because of a legitimate business choice.

Because of these inaccuracies in the testing rate, IBM might be forced to raise its installment sale interest rates above market or subject its customers to imputation of interest and the complexity of Section 1274, when the testing rate is too high.

The competitive situation facing IBM makes an interest rate increase burdensome. Purchasers may decide to finance the purchase of the product from other sources which do not fall within the ambit of section 1274, such as banks or other third party lenders.

If interest rates are not raised, the imputed principal amount established by section 1274 gives the installment sale purchaser a lower basis than that given to a cash purchaser of the same product. A lower basis decreases the benefit of the investment tax credit which the purchaser obtains, and therefore increases his cost of purchasing IBM products using IBM financing. Purchasers again could use other sources of financing including other third party lenders rather than IBM financing to achieve a basis equal to the cash price of IBM products.

Thus, in certain transactions, section 1274 places IBM at a competitive disadvantage vis-a-vis third party lenders and creates unwarranted inefficiencies for customers who want the convenience of IBM financing. This undesirable result is caused by application of a tax-avoidance provision to non tax-avoidance business transactions. IBM's fact pattern illustrates the arbitrariness of the current imputed interest rates. Illustration A clearly shows that the statute has failed to be ". . . a reasonable approximation of the rate at which a good credit risk with adequate security could borrow." General Explanation of the Revenue Provision of the Deficit Reduction Act of 1984, H.R. 4170, 98th Cong., 2d Sess. 115 (n.24) (Jt. Comm. Prt. December 31, 1984).

For these reasons, section 1274 should be amended by adding a provision directing the Secretary to issue regulations providing alternate methods of proving adequate stated interest. H.R. 2475 would authorize Treasury to issue regulations allowing taxpayers to prove a lower interest rate. Although Treasury has indicated in its statement its willingness to promulgate regulations, taxpayers need immediate assurance. By specifying that Treasury is directed, as contrasted with authorized, to issue regulations, this needed assurance would be provided. The effective date provisions should be clarified to indicate that the regulations will be retroactively effective to January 1, 1985.1/

1/ The imputed interest amendments of H.R. 2475 are to be effective June 30, 1985. The general effective date provision should indicate that regulations promulgated pursuant to the direction to Treasury are to be retroactively effective to January 1, 1985.

The legislative explanation accompanying the amendment to section 1274 should refer to the three concepts raised in the Treasury statement dealing with alternate methods of proving adequate stated interest:

(1) Alternate rates may be established according to the same principles as the applicable Federal rate, but with greater accuracy than the published rates 2/;

(2) Adequate stated interest may be established by reference to terms available from third party lenders 3/;

(3) Adequate stated interest may be established by showing that substantially identical property is regularly sold by the seller or its affiliates for cash at the same price to other purchasers.4/

In recommending these proposals, IBM Credit is quite conscious of concerns about the complexity of section 1274. In the interests of "simplicity", section 1274 was drafted

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2/ Neither H.R. 2475 nor the Treasury statement specifically address the distinction between balloon notes and obligations with more than one maturity date. IBM Credit believes that the proposals in H.R. 2475 and the Treasury statement to allow taxpayers to establish the adequacy of stated interest under principles similar to those of section 1274, in concept, should permit accounting for amortization of principal over the term of an obligation in establishing the adequacy of the stated interest rate, but specific immediate guidance through legislative explanation on the point is needed. In addition, IBM Credit believes that it is appropriate to provide further flexibility by specifying that the adequacy of the stated interest rate may be established, as an alternate, as of the date of the sale.

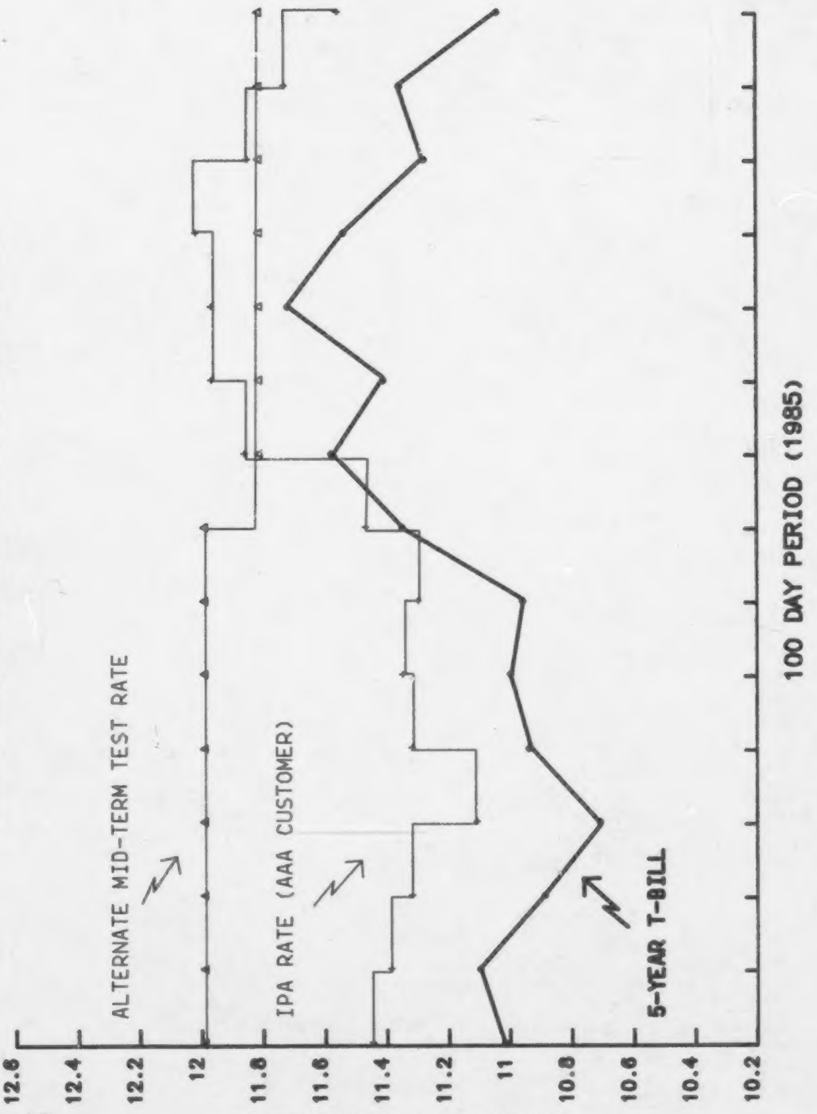
3/ The legislative explanation accompanying H.R. 2475 gives as an example of its regulatory authority the establishment of a lower rate if a taxpayer can demonstrate that he is able to borrow at rates less than the AFR from third parties.

4/ The Treasury Statement suggests a similar solution but uses the term "fungible" property. IBM Credit believes this term is too restrictive and could be construed to refer only to commodity products such as wheat, oil, etc.

with a limited number of testing rates and limited changes in those rates, thus trading preciseness for "simplicity". However, too many taxpayers have been subjected to the complexity of section 1274 and the need to consider its provisions in connection with every day non-tax motivated business transactions. The simplicity gained by the broad brush approach of portions of the statute is offset because of the number of additional transactions which must be tested.

There are two ways to restore simplicity to section 1274: (1) It can be made more precise so that taxpayers dealing at market rates will not have to be concerned with imputed interest at all; or (2) It can be made sufficiently imprecise in favor of no interest imputation (for example, a test rate set below the applicable federal rate) that many transactions escape its ambit. In making these recommendations, IBM Credit has generally adopted the first approach.

ILLUSTRATION A
COMPARATIVE MONTHLY INTEREST RATES



COMMENTS ON BEHALF OF THE NEW YORK STATE MORTGAGE LOAN ENFORCEMENT AND ADMINISTRATION CORPORATION NEW YORK, NEW YORK FOR THE PRINTED RECORD OF THE HEARING

Submitted by
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Tax Treatment of Imputed
Interest on Deferred Payment
Sales of Property
Senate Finance Committee
May 20, 1985

This statement is made on behalf of the New York State Mortgage Loan Enforcement and Administration Corporation ("MLC") and is directed specifically to the application of the term "modification" to transactions undertaken by MLC.

MLC is a subsidiary of the New York State Urban Development Corporation ("UDC"). MLC is responsible for $1.2 billion of subsidized, low-income housing loans originated by UDC. Most of this housing was built pursuant to the HUD assisted but uninsured Section 236 Program and carries low rates of interest. Many of our uninsured project mortgages have experienced financial problems and currently have debt service arrears in excess of $140 million.

To make needed repairs to maintain the facilities and to avoid foreclosure, these projects need to attract investors who are willing to contribute cash and assume ownership and operation of the property. The infusion of capital, combined with the deferral of debt service, enables the new owners to make the capital contributions and improvements required to stabilize the operations of the properties and to attract tenants so that the cash flow from the property will become sufficient to meet its operation costs, including debt service, normal operating expenses and repairs. Unfortunately, the adoption of the original issue discount and imputed interest ("OID") rules has had a significant adverse impact on the ability of these troubled low-income properties to attract investors having the cash to make contributions.

Failure to raise needed capital will result in further deterioration of this valuable housing stock which cannot be replaced due in part to the elimination of Federal programs for low-income tenants. Even if new production programs did exist, however, the cost of duplicating these projects has increased three fold since the mid-1970's, when the programs were introduced. It makes no sense not to preserve this valuable housing stock.

The OID rules, as enacted by the Tax Reform Act of 1984 ("TRA"), provide the stated interest on debt obligations must be at least 110% of the applicable Federal rate, or interest will be imputed at 120% of the applicable Federal rate. Moreover, interest must be computed on a compound, rather than simple basis, reducing interest deductions in the early years of a loan and increasing them in the later years. Finally, both buyers and sellers must account for this interest on the accrual method of accounting. Accordingly, interest will be deductible by the buyer and reportable as income by the seller as it accrues, regardless of whether any cash is paid. Under this rule, sellers are required to report income even though they receive no current income. Moreover, the application of the imputed interest rules operates to reduce the depreciable basis of property.

The financial impact of these rules on real estate transactions was dramatically illustrated by David A. Smith, a Vice

President and principal of Boston Financial Technology Group, Inc., in an article published in the winter 1985 edition of Real Estate Review. Mr. Smith compared the tax impact of a sale of a building under rules in place before and after TRA.

Mr. Smith's article highlighted the impact of the OID rules on both the purchaser and the seller. Under the facts of his basic example, a buyer purchased a building from a cash basis seller, paying the seller's $1 million purchase price in the form of a purchase money note, bearing accrued, but unpaid, simple interest at 9%.

Under pre-TRA rules, the buyer depreciated the $1 million purchase price over the 15-year term of the note and deducted currently accrued but unpaid interest of $1.35 million, giving him a terminal indebtedness of $2.35 million. If the property appreciated 5.86% per year, it would have a value of $2.35 million at the end of the 15-year period, enabling the buyer to satisfy his indebtedness by selling the property. Smith's calculations show that the net present value of the buyer's holding period benefits, exclusive of residuals and termination taxes, was $688,849.

These results were changed significantly by the OID rules. Under OID, to maintain a terminal indebtedness of $2.35 million (and assuming that 110% of the applicable Federal rate is 14.3%), the principal amount of the purchase money note cannot exceed $316,500. This is less than one-third of the principal of the pre-TRA note. When the investment ends in year 15, the net present value of the holding period benefits is $548,939. This is 20% lower than pre-TRA benefits. TRA also caused approximately $683,499 of depreciable basis to be converted into accrued but unpaid interest. Under the OID rules, the deductibility of the major portion of this interest is deferred to the later years. Furthermore, much of the seller's capital gain has been converted into ordinary income. In the pre-TRA example, the seller would have paid $975,000 in taxes. Under TRA, he will be liable for approximately $1,111,700 in taxes, an increase of approximately 11%. Moreover, the application of the OID rules will cause the portion of his taxes attributable to interest to be taxed before he receives any cash from the sale of the property.

With results like this, it is no small wonder that the number of real estate transactions using deferred-payment financing have dropped significantly.

On October 11, 1984, Congress adopted legislation providing transitional rules for the imputed interest provisions enacted by TRA. This legislation provides that for sales or exchanges of real property and personal use property occurring before July 1, 1985, involving borrowed amounts of up to $2 million, no interest will be imputed if the parties state at least a 9% compound interest rate (or "test rate"). If the parties fail to state a 9% compound interest rate, interest will be imputed at a 10% compound rate. If the borrowed amount exceeds $2 million, the excess will be subject to an interest rate which equals the excess of 110% of the applicable Federal rate over 9% when the test rate is stated, or an interest rate equal to the excess of 120% of the applicable Federal rate over 10% when interest is imputed.

The October 11, 1984, legislation also exempted from the imputed interest provisions the assumptions of loans made before October 15, 1984, except for assumptions in connection with transactions involving a purchase price of $100 million or more. This exception for assumption of loans applies, however, only if the terms and conditions of the debt obligation are not "modified" in connection with the transaction. The critical issue in this regard is what will constitute a "modification" of a debt obligation.

Under the usual resyndication structure utilized with a troubled project, investors assume existing debt on property. To make subsidized housing projects that have debt service payments in arrears attractive to investors, the practice in the industry has been to execute "work-out" agreements under which a lender agrees to forebear on foreclosure, to defer debt service arrearages and/or to permit future debt service shortfalls in conjunction with the assumption of the debt. It is critical that these "work-out" agreements are not treated as "modifications" of the assumed debt obligations since such treatment would subject the debt obligations to the new OID rules.

Most "work-out" agreements contemplate a deferral of the payment date of the debt obligation. Under Treasury Regulation 1.483-1(f)(1), a delay in payment of over 90 days is treated as a change in the terms of a contract. Were "modification" to be defined in the same manner, "work-out" agreements would subject the assumed loan to the OID rules since the deferral of payment is central to the concept of "work-out" agreements.

Subjecting troubled projects to the OID rules will not only inhibit investment in these projects, but will also create additional cash flow problems. In the absence of OID application, the below-market interest rate would carry over to the purchaser, resulting in payments to the mortgagee that are significantly less than they would be had the entire purchase price been newly-financed. The reduced payments benefit the project in that more funds are available for project improvements and other expenses of the project.

It must be recognized that properties on which "work-outs" would be implemented are subsidized, low-income housing projects. Congress has, over the years, repeatedly recognized the special status of low-income projects and provided special tax treatment for investors to encourage them to invest in low-income housing. The special treatment offsets the market limitations on rents and the limited amount of cash flow profit a subsidized, low-income housing project can earn. In the Tax Reform Act of 1969, Congress first adopted a different treatment of depreciation for subsidized and conventional housing by permitting more favorable rules of recapture of excess depreciation for low-income housing and by adding Code section 167(k) to allow 5-year depreciation for rehabilitation expenditures for low-income housing.

In 1981, the accelerated cost recovery system elevated depreciation benefits for existing housing to the same level as for new construction, while continuing a preference for low-income housing under the 200% declining balance method of depreciation (versus 175% for other housing). Most recently, TRA retained 15-year depreciation benefits for low-income housing, while changing all other real estate to an 18-year term.

The Treasury Department itself, moreover, has accorded low-income housing special treatment. Between 1978 and 1979, Treasury attempted to apply Code section 183, relating to so-called "hobby losses" or disallowance of losses from activities not engaged in for profit, to subsidized housing. After negotiations with HUD and others, Treasury issued Revenue Ruling 79-300, which states that the deductibility of losses on Section 236 projects would not be restricted by the Code section 183 "hobby loss" provisions. That ruling position has never been revoked.

To maintain the continued ability of certain projects to house the poor, rules regarding modifications of assumed loans should favor low-income housing. Housing projects currently in arrears in debt service cannot become viable, self-supporting projects without the infusion of additional capital. The additional equity required for capital improvements is found by selling the property to investors who are willing to risk their capital. In return, they demand, and rightly so, some benefits as consideration. Since there is no cash flow and no assurance of long-term appreciation, these benefits have historically taken the form of tax advantages. Were the OID rules to apply to mortgages assumed in such resyndications, depreciation deductions would be reduced. By reducing depreciation, one of the major tax advantages associated with owning real estate, few projects will be purchased by private-sector investors. The likely alternative is foreclosure. Since MLC's ability to sell the property after foreclosure is also significantly inhibited, it serves no one's needs.

Under S.217, introduced by Senator Melcher, the OID rules would not apply to any debt instruments by reason of the assumption of such instrument. To ensure the continued influx of private-sector funds into low-income subsidized housing, we recommend that the Committee adopt a similar provision. In the alternative, we recommend that all assumptions of loans relating to low-income housing be exempted from the OID rules. If a total exemption of assumptions is not acceptable, we recommend that the definition of the term "modification" exclude from its coverage all "work-out" agreements (i) which are entered into by a governmental entity holding, insuring or subsidizing the loan and (ii) which arise in the resyndication of low-income subsidized housing projects that carry below-market interest rates and have debt service in arrears.

I wish to comment on one further matter. Senator Durenberger and Congressman Matsui have introduced bills (S.729 and H.R. 2069, respectively) under which no interest will be imputed on the sale or exchange of property if (i) the parties state an interest rate equal to the lesser of 9% or 80% of the applicable Federal rate and (ii) the borrowed amount does not exceed $4 million. We recommend that the committee adopt provisions similar to those contained in these bills.

May 9, 1985

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SC-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. DeArment:

Please include this letter in the printed record of the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

The changes made to the "imputed interest rules" of Section 483 by the enactment of Section 1274, at least in the area of the sales of real property, have created un unmanageable complexity in an area of the tax law that is already too complicated to be understood by any taxpayer. In my opinion not even the average attorney, let alone the average taxpayer, could understand the present value-discounting rules of Section 483. Now you have added a further complication that will certainly eliminate almost all of the Internal Revenue Service agents from being able to understand and audit compliance with the law. Section 1274 is TOO COMPLICATED to be understood by all except mathematicians and CPA's.

In real estate transactions, I would suggest that there will be little compliance with the law unless both the purchaser and the seller have CPA's prepare their income tax returns. Furthermore, the IRS will not be able to monitor compliance because the vast majority of Internal Revenue agents will not be able to understand the "present value computations" of Section 1274.

To tie the interest rates on a seller carryback of real property to 120% of the interest rate charged on federal treasury instruments, thereby making the interest rate greater than that charged by commercial lenders, fails to recognize several significant economic differences between sellers of real property who "carry back" financing on the one hand and commercial lenders on the other hand.

(1) The commercial lender has a fully operating business staffed by several employees and involving a significant capital investment. The commercial lender has to charge two to three interest points above its cost of money to cover its cost of doing business, a return on its capital and a profit amount. The individual seller does not have such costs and, in most real property transactions, the seller of real property will carry back financing two to three interest points below commercial market rates because he has no cost of doing business.

(2) The interest rate that a seller receives on a carryback is generally equivalent to what such seller would receive from an investment in a fixed-income investment, such as treasury notes, corporate bonds, and bank savings accounts. Today, a commercial lender on a loan secured by real property is commanding a 13-3/4% to 14% rate. The current interest rate being paid on money market accounts is about 10-1/2%. On the other hand, 120% of the current short-term T-Note yield would be approximately 14.7%. Under Section 1274 the law requires the seller to report an interest income forty percent greater than what such seller would receive from available alternative investments.

(3) When the seller carries back financing, the debt instrument owned by the seller is secured by a lien on the property sold. In almost all cases the seller has "first rate security" for the payment of his loan. The greater the security, the lower the interest rate should be. On the other hand, if a person is willing to risk his capital, such as in the purchase of a corporate bond, then the interest rate should be higher. The upper interest rate level under Section 1274 should be equal to the treasury note yields, not 120% of such yields!

In enacting Section 1274 the economics of real property transactions were not adequately understood. In many real estate transactions, the time period between the parties entering into an Agreement for Sale and the actual closing of the transaction (i.e. the transfer of title and payment) can be several months to several years. For example, in a raw land transaction, the closing may be contingent upon rezoning or platting and, because of the governmental process, may be upwards of two years time span between the contract date and the closing date. Frequently, in a lease transaction, the lessee may be granted the option to purchase the property five or ten years later. All of the terms of the Purchase Agreement must be provided for in the lease/option agreement. In most real property transactions, the time difference between contractual agreement and closing is from 60 days to 180 days. In all of the above examples, because of the time lag, a contract could be entered into complying with the complicated rules of Section 1274 and prior to closing, the interest rates could change causing the transaction at closing to no longer comply with Section 1274. Congress has created an intolerable situation for real property transactions in that people who are entering into contractual agreements will have no way of determining the tax consequences of such transactions at the time of signing such Real Property Purchase and Sale Agreements. One of the very basic tenets of tax law has been that it should be clear, understandable, and taxpayers should be able to measure the tax conseuqneces of their acts at the time they are entering into agreements. This cannot be accomplished in a real estate transaction under Section 1274.

Under the old rules of Section 483, a taxpayer could calculate the tax consequences of his acts. Under the new Section 1274, no one will be able to calculate the tax results of a transaction until after the closing. Furthermore, a reasonable rate of interest should be the measuring device, not a rate of interest that is in excess of a rate of interest charged by the most expensive of commercial real property lenders.

To force the parties to a real estate transaction to charge a rate of interest greater than treasury rates or commercial lending rates is a highly inflationary measure. Such a law is counterproductive to Congress' intent to reduce inflation.

If Section 1274 cannot be repealed, then the testing rate should be reduced to 80% of an appropriate treasury note yield and the top rate should be 90% of the appropriate treasury note yield. Furthermore, the rate should be the applicable rate at the date the contract is entered into, not the date of closing of the real estate transaction.

To change the rates would not have any appreciable effect on government revenues. Under Sections 483 and 1274, to the extent the seller's interest income is increased, the buyer's interest deduction is also increased, resulting in offsetting changes. In other words, for each dollar of additional interest income, there would be a matching dollar of interest deduction.

Sincerely,

Lawrence E. Wright
Broker Associate

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